86-1006

Supreme Court, U.S.
FILED
DEC 19 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-

IN THE

Supreme Court of the United States

October Term, 1986

MARATHON OIL COMPANY,
an Ohio corporation,

Petitioner,

v.

UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

GIBSON, DUNN & CRUTCHER
Charles J. Meyers,
Counsel of Record
A. Randall Farnsworth
Gregory J. Kerwin
Of Counsel:
John A. Carver, Jr.
1801 California Street,
42nd Floor
Denver, Colorado 80202
(303) 298-7200
Attorneys for Petitioner,
Marathon Oil Company

Of Counsel:
D. D. Sandman
G. H. Rothschild, Jr.
K. D. Hinkle

QUESTIONS PRESENTED

The Mineral Leasing Act of 1920 (MLA) instructs the Secretary of the Interior to collect a 12½% *royalty* on oil and gas production removed or sold from federal leases. The Secretary's collection agency, the Minerals Management Service (MMS), has through the process of informal adjudication asserted authority to collect not a royalty but a share of downstream manufacturing and transportation profits from Marathon's sale of Liquefied Natural Gas (LNG) in Japan, which is manufactured from natural gas produced on Marathon's federal leases in Alaska. The Court of Appeals deferred to the agency's novel interpretation of the statutory term "royalty" without determining that the statute was ambiguous.

The questions presented are:

1. Whether the Court of Appeals erred in deferring to an agency interpretation of a statutory term without finding the statute ambiguous and without examining Congress' intent in using a term having an established commercial meaning.

2. Whether the Court of Appeals erred in deferring uncritically to an agency's statutory interpretation without examining the reliability of the interpretation when it was unprecedented, unexplained, unrelated to the agency's expertise, and contrary to fifty years of prior agency practice.

LIST OF PARTIES AND RULE 28.1 LIST

The names of all the parties to the proceeding in the Ninth Circuit are listed in the caption of this petition.[1]

---

[1] Because Petitioner is a corporation, it submits the following list of related companies pursuant to Supreme Court Rule 28.1. Petitioner Marathon Oil Company is a wholly owned subsidiary of USX Corporation, and portions of its business are operated as separate, wholly owned subsidiaries of USX Corporation. In addition to its wholly owned subsidiaries, Marathon Oil Company is affiliated with the following entities:

Arctic LNG Transportation Company
Badger Pipe Line Company
City Point Oil Terminal, Inc.
CLAM Petroleum Company
Cook Inlet Pipe Line Company
Deutsche Transalpine Olleitung GmbH
Explorer Pipeline Company
Gravecap, Inc.
Green Bay Terminal Corporation
Kenai LNG Corporation
LOCAP, Inc.
LOOP Inc.
Oasis Oil Company of Libya, Inc.
Oil Insurance Limited
Petroleum Terminals, Inc.
Pilot Oil Corporation
Platte Pipe Line Company
Polar LNG Shipping Corporation
Russell Stewart Oil Co.
Societa Italiana Per L'Oleodotto Transalpino, S.p.A.
Transalpine Finance Holdings S.A.
Transalpine Olleitung in Osterreich Gmbh
West Shore Pipe Line Company
Wolverine Pipe Line Company

In addition to subsidiaries which are wholly owned, including Marathon, USX Corporation is affiliated with the following entities:

Athlone Prospecting & Development Corporation, Ltd.
First National Bank (Albion, Pa.)
Companhia Meridional de Mineracao
Alfa Produtos Metalurgicos, Ltda.
ITW-Mapri (51% owned by Alfa Produtos)
Mecania Walsywa, Ltda.
Companhia Siderugica Paulista "Cosipa"
Merinda Mineracao
Mineracao Buritirama Ltda.
Mineracao Carajas, Ltda.
Mineracao Maraba, Ltda.
Mineracao Xingu, Ltda.
Termerid Mineracao, S.A.
Torremco Soc. Min. E. Com. Ltda.
Deepsea Ventures, Inc.
Ocean Mining Associates
FHS Stablverformung GmbH
FHS Automotive Parts Manufacturing Ltd.
Industria de Tubos y Perfiles, S.A. (Intuperas)
Minerales Ordaz C.A.
Les Entreprises du Lac Lucault Inc.
Sidbee-Normines, Inc.
U.S. Steel France
Zierust Chrome Mines, Limited
USS Technology (Japan), Ltd.
ACE Holdings, Ltd.
Adela Investment Company, S.A.
Altos Hornos de Viscaya, S.A. (AHV)
Associated Ore & Metal Corporation, Ltd.
Avsteel SWA, Ltd.
Blue Grass Phosphate Company
Chrome Deposit Corp. (Court Holdings J.V.)
Kappa Mining & Prospecting Co., Ltd.
La Pointe Iron Company
Oresteel Investments (Proprietary), Ltd.
P. T. Pacific Wikkel Indonesia
Sigma Mining & Prospecting Co. (Pty.) Ltd.
Societe Des Mines De Fer De Guinea Pour L'Exploitation Des Monta Nimba (Mifergui Nimba)
Tilden Iron Mining Company
West Union Canal Company, The
Bartow Chemical Products
Century III Associates
Fort Meade Chemical Products
Double Eagle Steel Coating Co.
Live Oak Uranium Operations
Rockland Joint Venture
BMI Company
Tenneco/USS Chemicals Joint Venture
Compagnie Miniere de l'Ogooue (Comilog)
Feralloys, Ltd.
Assoc. Manganese Mines of South Africa, Ltd.
Prieska Cooper Mines (Pty.) Ltd.
Terminoss Acciai Inossidabili S.p.A.
Zuari Argo Chemicals Ltd.
USS-Posco Industries
Navios Shipping Corp.
USS-OCF-W&M Joint Venture

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statute and regulation involved	2
Statement of the case	4
Importance of the case	6
Reasons for granting the writ	7
I. The Court Below Erred In Deferring To An Erroneous Administrative Interpretation Of An Unambiguous Statute	7
II. The Traditional Tests For Reliability Of Agency Interpretation Were Not Applied In This Case	13
A. Application Of The Criteria Of Reliability In This Case Indicates That Deference Was Unwarranted	14
B. This Case Is An Appropriate Vehicle To Instruct The Lower Courts On The Continuing Need To Apply Reliability Criteria To Agency Interpretations As Well As To Correct The Particular Error By The Ninth Circuit	18
Conclusion	21

TABLE OF AUTHORITIES

CASES:

Alcaraz v. Block, 746 F.2d 593 (9th Cir. 1984) 19

American Federation of Labor v. Donovan, 757 F.2d 330 (D.C. Cir. 1985) 18

American Tobacco Co. v. Patterson, 456 U.S. 63 (1982) 12

Batterton v. Francis, 432 U.S. 416 (1977) 14, 18

Board of Governors v. Dimension Financial Corp., 106 S. Ct. 681 (1986) 8, 9, 12, 15

Center for Auto Safety v. Ruckelshaus, 747 F.2d 1 (D.C. Cir. 1984) 18, 19

Chemical Manufacturers Ass'n v. Natural Resources Defense Council, Inc., 470 U.S. 116 (1985) 8, 15

Page

Chevron, USA, Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 6, 8, 13, 15, 16, 17, 19, 20, 21

Cox v. United States, 497 F.2d 348 (4th Cir.), *cert. denied*, 419 U.S. 1047 (1974) 11

FEC v. Democratic Senatorial Campaign Committee, 454 U.S. 27 (1981) 8, 16

Gibson v. Berryhill, 411 U.S. 564 (1973) 17

Greater Boston Television Corp. v. FCC, 444 F.2d 841 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971) 16

In re Murchison, 349 U.S. 133 (1955) 17

Investment Company Institute v. Camp, 401 U.S. 617 (1971) 17

Louisiana Land & Exploration Co. v. Donnelly, 394 F.2d 273 (5th Cir. 1968) 10

Marathon v. United States, No. 85-3800 (9th Cir. July 24, 1986) 1, 2

Marathon v. United States, No. A83-208 Civil (D. Alaska May 1, 1985) 2, 6

Marathon v. United States, 604 F. Supp. 1375 (D. Alaska 1985) 2, 5

Marshall v. Jerrico, Inc., 446 U.S. 238 (1980) 17

Martin v. Glass, 571 F. Supp. 1406 (N.D. Tex. 1983), *aff'd per curiam*, 736 F.2d 1524 (5th Cir. 1984) 10

Mattox v. FTC, 752 F.2d 116 (5th Cir. 1985) 19

Mayburg v. Secretary, 740 F.2d 100 (1st Cir. 1984) 19

Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29 (1983) 15, 16

Natural Resources Defense Council v. Thomas, ___ F.2d ___, No. 85-1296, Slip op. at 22, n.20 (D.C. Cir. Nov. 7, 1986) 19

Patterson v. Texas Co., 131 F.2d 998 (5th Cir. 1942), *cert. denied*, 319 U.S. 761 (1943) 10

Phillips Petroleum Co. v. Record, 146 F.2d 485 (5th Cir. 1944) ... 11

Probst v. Ingram, 373 P.2d 58 (Okla. 1962) 10

Red Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969) 8

SEC v. Sloan, 436 U.S. 103 (1978) 8, 16

Simmons v. ICC, 766 F.2d 1177 (7th Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986) 19

Tumey v. Ohio, 273 U.S. 510 (1927) 17

Udall v. Tallman, 380 U.S. 1 (1965) 8

United States v. Riverside Bayview Homes, Inc., 106 S. Ct. 455 (1985) 8

Page

Wall v. United Gas Public Service Co., 178 La. 908, 152 So. 561 (1934) 10

Watt v. Alaska, 451 U.S. 259 (1981) 15

Ward v. Village of Monroeville, 409 U.S. 57 (1972) 17

Withrow v. Larkin, 421 U.S. 35 (1975) 17

Wright v. Brush, 115 F.2d 265 (10th Cir. 1940) 10

Young v. Community Nutrition Institute, 106 S. Ct. 2360 (1986) 8, 16

STATUTES, REGULATIONS AND RULES:

5 U.S.C. § 706 9

28 U.S.C. § 1254(1) 2

28 U.S.C. § 1331 5

Mineral Leasing Act of 1920, 30 U.S.C. § 226 ..... 2, 3, 4, 5, 6, 7, 9, 10, 13, 15

Outer Continental Shelf Lands Act Amendments of 1978, 43 U.S.C. § 1337(a)(1) 12

30 C.F.R. § 206.103 ..... 3, 4

43 C.F.R. § 3000.0-5(a) 4

Supreme Court Rule 20.4 2

MISCELLANEOUS:

Brief for the United States of America, Appellee (filed in *Marathon v. United States*, No. 85-3800 (9th Cir.)) 5

Byse, *Scope of Judicial Review in Informal Rulemaking*, 33 Ad. L. Rev. 1983 (1981) 14

R. Hemingway, *The Law of Oil and Gas* (2d ed. 1983) 11

Interpretation of Oil and Gas Regulations, 56 Interior Dec. 462 (1937) 11

E. Kuntz, *Law of Oil and Gas* (1978) 11

Sneed, *Value of Lessor's Share of Production Where Gas Only is Produced*, 25 Tex. L. Rev. 641 (1947) 11

Starr, *Judicial Review in the Post-Chevron Era*, 3 Yale J. on Reg. 283 (1986) 18

H. Williams & C. Meyers, *Oil and Gas Law* (1985) 11

No. 86-

IN THE

Supreme Court of the United States

October Term, 1986

MARATHON OIL COMPANY,
an Ohio corporation,

Petitioner,

v.

UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The petitioner, Marathon Oil Company, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled proceeding on July 24, 1986.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit was originally reported at 794 F.2d 1461, and then withdrawn from West's bound volume because on July 25, 1986 the Court of Appeals temporarily withdrew the opinion from publication. The opinion is reprinted in Appendix A, at p. 2a.

The opinion of the District Court for the District of Alaska is reported at 604 F. Supp. 1375, and is reprinted in Appendix B-2, at p. 22a. The District Court's order of May 1, 1985 enjoining Marathon to comply with MMS's orders is unpublished, and is reprinted in Appendix B-1, at p. 18a.

JURISDICTION

The Ninth Circuit entered its opinion and judgment on July 24, 1986. Appendix A, at p. 2a. Petitioner filed a petition for rehearing and suggestion of rehearing *en banc,* and the Ninth Circuit has requested the United States to submit a response. *See Marathon v. United States,* No. 85-3800, *Order* (9th Cir. September 30, 1986), reprinted in Appendix D-5, at p. 80a. The petition for rehearing is still pending but its pendency does not affect Petitioner's time in which to seek certiorari because the petition was deemed to be late, though ordered filed. *See* Supreme Court R. 20.4.

On October 3, 1986, Justice O'Connor extended the time for filing this petition for writ of certiorari to and including December 21, 1986.

Petitioner invokes the jurisdiction of this Court to review the judgment of the Ninth Circuit under 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Excerpt from the Mineral Leasing Act of 1920, 30 U.S.C. § 226(a),(c).

§ 226. Lease of oil and gas lands

(a). All lands subject to disposition under this chapter which are known or believed to contain oil or gas deposits may be leased by the Secretary.

* * * *

(c). If the lands to be leased are not subject to leasing under subsection (b) of this section, the person first making application for the lease who is qualified to hold a lease under this chapter shall be entitled to a lease of such lands without competitive bidding. Such leases shall be conditioned upon the payment by the lessee of a royalty of 12½ per centum in amount or value of the production removed or sold from the lease.

30 C.F.R. § 206.103

§ 206.103 Value basis for computing royalties.

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

STATEMENT OF THE CASE

This case arises over the Minerals Management Service's (MMS) 1983 reinterpretation of the Mineral Leasing Act of 1920 (MLA) and the royalty clause in thirty-year old producing oil and gas leases located in the Kenai Field in Alaska. Marathon owns a 50% interest in the leases, which produce natural gas, some of which is used by Marathon in the manufacture of Liquefied Natural Gas (LNG) that is shipped from Alaska in specially designed and constructed tankers and sold in Japan for heating, cooling and fuel uses under a long-term contract.[2] Marathon also sells natural gas from the leases at the wells to other purchasers under arms-length contracts.

In accordance with the MLA, 30 U.S.C. § 226(c) (1982), the federal leases provide that "royalty" shall be paid in the amount of 12½% on "production removed or sold from the leased lands" computed in accordance with the operating regulations now codified as 30 C.F.R. § 206.103 (1986). That regulation has remained substantially the same during the three decades the leases have been in effect.

During the first 11 years of Marathon's LNG project, the Department of the Interior (DOI) calculated the value of the feedstock gas on the basis of the highest price paid for natural gas under arms-length sales in the same field. Thereafter pursuant to a 1981 settlement agreement with Marathon, DOI

---

[2] Marathon has contended from the beginning that LNG is not natural gas and submitted an expert's affidavit to that effect to the district judge. The Department of the Interior's regulations define gas as "any fluid, either combustible or noncombustible, which is produced in a natural state from the earth and which maintains a gaseous or rarefied state at ordinary temperatures and pressure conditions." 43 C.F.R. § 3000.0-5(a). LNG is not only liquid but has refrigerant qualities and can be conveniently stored above ground, both of which properties also distinguish it from natural gas. These points, and the chemical differences between LNG and natural gas, were made in the *amicus* brief of the American Petroleum Institute in the Ninth Circuit.

valued such gas on the basis of one of the higher values prevailing in the entire Cook Inlet. At issue in this case are MMS orders that abandon the settlement agreement and establish a netback valuation methodology that values the government's royalty on natural gas produced in Alaska at the price of LNG sold in Japan less some cost allowances. These orders change the government's leasehold interest from the royalty interest provided for in the MLA to what the Secretary concedes is a profit-sharing interest.[3] This methodology arrogates to the government — risk free — a substantial portion of Marathon's downstream manufacturing and trans-Pacific transportation profits. The netback orders thus adversely affect numerous federal oil and gas lessees who have invested millions of dollars in plants and equipment to manufacture gas produced from federal leases into other products.

Petitioner commenced this action in the United States District Court for the District of Alaska seeking a declaration that MMS had exceeded its authority in ordering Petitioner to utilize a netback formula to calculate the royalty owing on gas produced on Petitioner's oil and gas leases on federal land in Alaska. The District Court had subject matter jurisdiction over this action under 28 U.S.C. § 1331 because the case presents a federal question. The District Court granted the federal defendants' motion for summary judgment on February 20, 1985, *see Marathon Oil Co. v. United States,* 604 F. Supp. 1375 (D. Alaska 1985), Appendix B-2, at p. 22a, and permanently enjoined Petitioner to comply with the MMS Orders on May 1,

---

[3] Marathon complains that any royalty valuation methodology which has as its starting point the price which Marathon receives in Japan will have the effect of permitting the government to share in Marathon's "entrepreneurial profits" which are purportedly the result of the efforts which Marathon put forth, and the risks which it ran, in participating in the development of the Japanese LNG market. That consequence, however, was foreordained by the gross proceeds provision of the regulation which was in effect when Marathon's leases were issued and at all times since.

Brief for the United States of America, Appellee, at 33 (filed in October 1985 in *Marathon v. United States,* No. 85-3800 (9th Cir.)).

1985, *see Marathon Oil Co. v. United States, Order,* No. A83-208 Civil (D. Alaska May 1, 1985), Appendix B-1, at p. 18a. Petitioner took an interlocutory appeal from the District Court's permanent injunction and award of summary judgment.

The Ninth Circuit's decision, which upheld the MMS orders, has implications beyond the validation of the agency's orders. The Ninth Circuit decision essentially abrogates the responsibility of the courts to enforce plainly expressed congressional intent when an administrative agency interprets a statute. The Ninth Circuit determined that it must defer to MMS' unprecedented interpretation of the statutory term "royalty," although the court found no ambiguity in the statutory language. Moreover, the court gave no consideration whatsoever to the reliability of the agency's determination. In so doing that court veered sharply from the principles of judicial review established in the decisions of this Court. Certiorari should be granted to correct the error in this case and to prevent such errors in the future.

IMPORTANCE OF THE CASE

Here the Department of the Interior has illegally claimed millions of dollars of Marathon's downstream manufacturing and transportation profits by excising the word "royalty" from the Mineral Leasing Act and substituting in its place the words "profit-sharing interest." This impermissible change in the statute by informal agency action affects not only Marathon's LNG manufacturing enterprise but threatens all federal oil and gas lessees who use oil or gas as feedstock for such manufactured products as plastics, fertilizer and refinery products. The case also raises several important issues of administrative law, which this Court should resolve in order to implement its holding in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984). Those issues are whether a court may defer to an agency statutory interpretation without first ascertaining whether the statutory terms are ambiguous so as to require interpretation and whether a court may ignore the reliability of an agency's interpretation when deferring to it.

REASONS FOR GRANTING THE WRIT

I.

THE COURT BELOW ERRED IN DEFERRING TO AN ERRONEOUS ADMINISTRATIVE INTERPRETATION OF AN UNAMBIGUOUS STATUTE.

The Ninth Circuit has invoked principles of deference to shirk its responsibility to review unlawful agency action and its duty to ensure agency compliance with a clear congressional mandate. The court resolved Marathon's contention that the agency's informal action was contrary to Congress' command in the Mineral Leasing Act of 1920, 30 U.S.C. § 226(c), to collect a "royalty," by simply deferring to the agency's interpretation of the statutory term, even though that interpretation was contrary to the plain meaning of the statute, the legislative history of the Act, longstanding agency interpretation of the Act and the relevant regulation, and ordinary commercial usage in the oil and gas industry. In electing to defer to the agency, the Ninth Circuit never analyzed whether the statute and legislative history were unclear. The Ninth Circuit simply stated:

> The agency's interpretation of the applicable statute is entitled to substantial deference, particularly if the agency is charged with administering the statutes. *See Chevron, U.S.A., Inc. v. National* [sic] *Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984).

Appendix A, at p. 10a.

In failing to inquire into Congress' intent as expressed in the words Congress chose and the reasons it gave, the Ninth Circuit has treated deference as an excuse for ignoring congressional intent. The influence of the decision thus extends far beyond the parties' royalty dispute because it affirms unlawful agency action, condones future agency disregard of congressional mandates, and adds to the confusion in the lower federal courts over when deference to agency legal interpretations is unwarranted.

A court reviewing an agency's construction of a statute must conduct a threshold inquiry into Congress' intent: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 842-43 (1984) (footnote omitted). Thus, in *Chevron,* this Court explicitly reaffirmed the line of cases holding that the "judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent. . . . If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." 467 U.S. at 843 n.9 (citing cases including *FEC v. Democratic Senatorial Campaign Committee,* 454 U.S. 27, 32 (1981) and *SEC v. Sloan,* 436 U.S. 103, 117-118 (1978)); *see also Chemical Manufacturers Ass'n v. Natural Resources Defense Council, Inc.,* 470 U.S. 116, 125 (1985). *Chevron* and subsequent decisions of this Court implicitly rejected the approach taken in some earlier cases that suggested that a court may defer to an agency's statutory interpretation without first examining congressional intent. *Compare Red Lion Broadcasting Co. v. FCC,* 395 U.S. 367, 381-82 (1969) and *Udall v. Tallman,* 380 U.S. 1, 16-17 (1965) *with Board of Governors v. Dimension Financial Corp.,* ____ U.S. ____, 106 S. Ct. 681, 686, 688-89 (1986); *United States v. Riverside Bayview Homes, Inc.,* ____ U.S. ____, 106 S. Ct. 455, 461 (1985); *Chemical Manufacturers Ass'n,* 470 U.S. at 125-26 (opinion of the Court) and 470 U.S. 134, 151-52 (Marshall, J., dissenting); *Young v. Community Nutrition Institute,* ____ U.S. ____, 106 S. Ct. 2360, 2367-68 (1986) (Stevens, J. dissenting). Specifically, and applicable here, this Court has refused to defer to an agency's interpretation of a statutory term when the agency's interpretation is contrary to the accepted commercial usage of

the term and nothing in the statute or legislative history indicated that Congress intended to deviate from ordinary commercial usage. *Dimension Financial Corp., supra,* 106 S. Ct. at 688 (rejecting agency interpretation of "commercial loan" because it was contrary to ordinary commercial usage of that term).

Consequently, in *Chevron* this Court gave effect to Congress' command in the Administrative Procedure Act that: "To the extent necessary to decision and when presented, *the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions,* and determine the meaning or applicability of the terms of an agency action." 5 U.S.C. § 706 (emphasis added).

The threshold requirement for deference in *Chevron* requires the reviewing court, when an agency interpretation of a statute is challenged, to analyze and explicitly find, as a matter of law, that the statute and legislative history are ambiguous on the disputed issue. This Court employs that process as a matter of course and should demand no less from the lower federal courts. The Ninth Circuit made no pretense of examining the text and legislative history of the MLA; instead it simply skipped the first step in the *Chevron* analysis and proceeded to endorse an erroneous agency interpretation of the Act.

If instead of skipping entirely an examination of the text and legislative history of the MLA, the Court of Appeals had carefully analyzed the statute and legislative history of the MLA as required by *Chevron,* it would have found the case to be analogous to *Board of Governors v. Dimension Financial Corp.,* ____ U.S. ____, 106 S. Ct. 681, 686, 688-89 (1986). The term Congress adopted, "royalty," has had an accepted commercial usage in the mining industry for several centuries, and Congress gave no indication in the MLA that it intended a different meaning to apply in federal oil and gas leases. On the contrary, Congress knew what royalty meant and intended to adopt the ordinary commercial meaning.

MLA was enacted in 1920, during an earlier era of administrative law when non-delegation was still the norm: Congress gave agencies specific instructions to carry out delegated tasks and left no room for the agencies to make new law or change old law through the guise of statutory interpretation. In the MLA, Congress instructed the Secretary of Interior to collect from federal lessees a "royalty of 12½ per centum in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(c). Congress' command was clear. The Government's interest in federal oil and gas leases is a *royalty* and it attaches to production of hydrocarbons as they are removed or sold from the lease. The government may elect to take its royalty in kind at the lease or in equivalent value, also at the lease. The plain meaning of the statute, as well as general oil and gas law, dictates that the boundaries of the leasehold establish the place where valuation takes place for all gas sold or otherwise removed from the lease. Thus the royalty payable on Alaska feedstock gas should not be calculated on the sales price of LNG in Japan.

Under general oil and gas law, it is well established that the value of gas, for royalty purposes, is based on market value at the wellhead. In *Wall v. United Gas Public Service Co.,* 178 La. 908, 152 So. 561 (1934), the Louisiana Supreme Court held that gas royalties must be calculated at the wellhead because this is when the lessee comes into possession of the gas. *See also Louisiana Land & Exploration Co. v. Donnelly,* 394 F.2d 273, 277 (5th Cir. 1968); *Patterson v. Texas Co.,* 131 F.2d 998, 1001 (5th Cir. 1942), *cert. denied,* 319 U.S. 761 (1943); *Wright v. Brush,* 115 F.2d 265, 267 (10th Cir. 1940); *Martin v. Glass,* 571 F. Supp. 1406, 1410 (N.D. Tex. 1983), *aff'd per curiam,* 736 F.2d 1524 (5th Cir. 1984); *Probst v. Ingram,* 373 P.2d 58, 61-62 (Okla. 1962).

The Department of the Interior had been consistently employing the standard industry usage of the term "royalty" prior to the time Congress amended the MLA in 1946 to

provide for a flat 12½% royalty for non-competitive leases instead of a variable royalty of "not less than" 12½%. On June 7, 1937, the Acting Secretary of Interior stated,

> Leases issued under [MLA] contemplate that a single royalty may be collected upon the value of the natural gas in the condition in which it comes from the well. . . . [He noted operating regulations that provided:] The Government does not wish to collect royalty on that part of the value which is derived from the cost of manufacturing, *inasmuch as the Government's equity is confined to the value of the raw material involved.*

Interpretation of Oil & Gas Regulations, 56 Interior Dec. 462, 462-63 (1937) (emphasis added).

In the mining industry, a royalty is a cost-free share of production. A net-profits interest is a share of profits from production after costs have been deducted. 5 E. Kuntz, *Law of Oil and Gas* §§ 63.1, 63.5 (1978); 2 H. Williams & C. Meyers, *Oil and Gas Law* § 424, at 438 (1985); *see also Cox v. United States,* 497 F.2d 348, 351 n.3 (4th Cir.) (net profits "represents a fractional share of the *profit* of the operating company" while a royalty is "a fractional share of the *minerals themselves as produced*" (emphasis added)), *cert. denied,* 419 U.S. 1047 (1974). Because a royalty interest is a fractional interest in raw production, as opposed to a share of net profits, a royalty owner may not attempt to recover a royalty payment which is based on the value of products manufactured from leasehold production. *Phillips Petroleum Co. v. Record,* 146 F.2d 485, 486 (5th Cir. 1944); Sneed, *Value of Lessor's Share of Production Where Gas Only is Produced,* 25 Tex. L. Rev. 641, 648, 650 (1947). Thus, a royalty does not entitle its owner to any part of the lessee's downstream manufacturing and transportation profits. It is a passive right to receive a portion of the production from a lease, either in kind or in value. *See* R. Hemingway, *The Law of Oil and Gas* § 2.5, at 52 (2d ed. 1983).

Congress specifically chose to retain the word royalty in 1946, aware of the Department of the Interior's and the oil and gas industry's unchanged definition of the term. If Congress had intended to grant the Government a net profits interest, it could and would have done so expressly in 1920, 1946, or subsequently. *See American Tobacco Co. v. Patterson,* 456 U.S. 63, 68 (1982) (legislative purpose is expressed by the ordinary meaning of words used). Where Congress has contemplated net profit sharing in lieu of a straight percentage royalty on the value of production, it has said so expressly. For example, in the Outer Continental Shelf Lands Act Amendments of 1978, 43 U.S.C. § 1337(a)(1)(D)-(F) (1982), Congress permitted the Department of the Interior to consider a variety of bidding systems, some of which expressly included net profit sharing elements, but Congress chose not to make comparable changes in the MLA for on-shore federal leases.

Despite Congress' use of the term "royalty," the MMS in 1983 ordered Marathon Oil Co. to begin paying a share of the profits from the sale in Japan of its manufactured product, LNG, as the "royalty" due under the leases. The Government has since admitted that it intended by this order to share in Marathon's downstream enterpreneurial profits. *See* footnote 3, *supra.* MMS thus chose an impermissible means for amending a statute — that of informal agency adjudication — rather than the constitutional means of changing a law through congressional action. As this Court explained in *Dimension Financial Corp.:* " The statute may be imperfect, but the Board has no power to correct flaws that it perceives in the statute it is empowered to administer. Its rulemaking power is limited to adopting regulations to carry into effect the will of Congress as expressed in the statute." 106 S. Ct. at 689.

In sum, this Court's precedents require a threshold inquiry into the statute and legislative history prior to exercising deference to an agency's statutory interpretation. The Court of Appeals did not follow these precedents: it did not find the

statute's reference to "royalty" to be ambiguous, yet it chose to defer to the agency's interpretation of that statutory term anyway. Had the Ninth Circuit engaged in the proper inquiry it would have found a clear expression of congressional intent in the statute and legislative history. Consequently, the court's decision condones an erroneous interpretation of a statutory term that is of significant importance to all lessees of federal oil and gas lands. Equally important, the decision exacerbates the confusion in the lower federal courts about when deference to an agency's legal interpretation is appropriate; it creates the impression that courts can defer to agencies without first conducting an independent inquiry into Congress' intent.

This case is an appropriate vehicle for instructing the lower courts on the meaning of *Chevron* and the necessity of conscientiously applying the traditional threshold test of congressional intent. By reviewing the judgment below, the Court can also correct the specific error of the Ninth Circuit and protect Petitioner and the industry from unwarranted monetary claims.

II.

THE TRADITIONAL TESTS FOR RELIABILITY OF AGENCY INTERPRETATION WERE NOT APPLIED IN THIS CASE.

Even if the Court of Appeals had engaged in the threshold inquiry into Congress' intent and somehow concluded that the Mineral Leasing Act's reference to "royalty" was ambiguous, it still would have erred if it had deferred to the MMS' interpretation of this term because of the circumstances surrounding MMS' adoption of that interpretation. The Ninth Circuit's decision illustrates the lower federal courts' confusion since *Chevron;* in many cases the courts believe they *must* automatically defer to an agency on a question of law even though certain danger signals arising from the circumstances of the agency's interpretation counsel against such deference. *Chevron* did not overrule prior cases holding that the circumstances

of an agency's interpretation should affect the decision to defer. Yet the lower federal courts, including the Ninth Circuit in this case, have forgotten these cases in their rush to embrace the doctrine of deference. As Professor Byse has explained, "The question is not whether the agency's interpretation shall be 'considered' or 'taken into account.' The precise problem is the extent to which the agency's interpretation shall affect or control the court's interpretation." Byse, *Scope of Judicial Review in Informal Rulemaking*, 33 Ad. L. Rev. 183, 191 (1981). This Court should reaffirm and clarify, in light of *Chevron*, its cases addressing the circumstances in which an agency's legal interpretation may be unreliable. The instant case presents an excellent opportunity for such clarification because the agency's interpretation involves nearly all of the traditional factors that make an agency interpretation unreliable, yet the Ninth Circuit did not even address the issue.

A. Application Of The Criteria Of Reliability In This Case Indicates That Deference Was Unwarranted.

This Court has always deemed an agency's legal interpretation to be more or less reliable and worthy of deference depending on the circumstances. *See, e.g., Batterton v. Francis*, 432 U.S. 416, 424-26 & nn. 8-9 (1977). Those circumstances include: 1) the scope of Congress' delegation to the agency; 2) agency expertise; 3) the timing and consistency of the agency's interpretation; 4) the thoroughness of the agency's explanation for its position; 5) the authority of the agency official advancing the interpretation; and 6) the extent to which the agency's self-interest deprives it of objectivity.

First, when Congress gives an agency wide latitude to interpret a statute, set policy, and fill gaps in the statutory framework, a court should be more willing to defer to an

agency on a question of law.[4] Deference in this circumstance actually amounts to deference to Congress, which chose to delegate broad authority to the agency in the first place. Especially after *Chevron,* judicial review should be focused on the question whether the agency exercised legitimate law-making authority. In this case, Congress gave no discretion to the Secretary to redefine the term "royalty" and change a clearly expressed congressional mandate.

Second, when an agency has developed expertise in a specialized area its legal interpretation is more likely to be worthy of deference.[5] Royalty does not involve complex, technical matters. It is a dictionary term capable of straightforward application. No deference is due to MMS on grounds of expertise when no question of expertise is presented.

Third, the reliability of an agency's legal interpretation depends on its timing and consistency, *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.,* 463 U.S. 29 (1983). Indeed, this Court has rejected a DOI interpretation of the Mineral Leasing Act concerning distribution of oil and gas revenues in Alaska when the Department reversed and sought to abandon its prior longstanding interpretation of the Act. *See Watt v. Alaska,* 451 U.S. 259 (1981). The Court noted that "[t]he Department's contemporaneous construction carries persuasive weight" and that "[t]he

---

[4] *See, e.g.,* Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-44, 865 (1984) (Court deferred to EPA on matters over which EPA had broad policymaking authority to fulfill Congress' mandate to clean up the nation's air).

[5] *See, e.g., Chemical Manufacturers Ass'n,* 470 U.S. at 125 (noting propriety of deference when statute is complex); *Chevron,* 467 U.S. at 844, 865 (deference proper when "full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations"; particular regard displayed for agency's interpretation on "technical and complex" matters); *cf. Dimension Financial Corp.,* 106 S. Ct. at 686 (no amount of agency expertise can vary a clear term in a statute).

Department's current interpretation, being in conflict with its initial position, is entitled to considerably less deference." *Id.* at 272-73. Again, the Ninth Circuit failed to consider this circumstance and ignored the fact that prior to this case DOI had never before attempted to define royalty to include a net profits interest.

Fourth, an agency's interpretation of a statute may be entitled to more or less deference depending on the thoroughness evident in the agency's explanation of its position.[6] An agency interpretation lacks power to persuade when it lacks a "concomitant exegesis of the statutory authority" supporting the agency's summary order. *SEC v. Sloan,* 436 U.S. 103, 118 (1978); *see also Motor Vehicle Mfrs. Ass'n,* 463 U.S. at 57 (rejecting agency decision changing course of policy because agency failed to "supply a reasoned analysis" for its decision and quoting *Greater Boston Television Corp. v. FCC,* 444 F.2d 841 (D.C. Cir. 1970)); *Community Nutrition Institute,* 106 S. Ct. 2366, 2368 n.3 (Stevens, J., dissenting) (deference not appropriate when agency never addressed in any detail the statutory authorization for the actions it has taken). An agency may not extend its regulatory authority by bootstrapping its way through a series of unexplained informal actions that exceed its statutory mandate. *SEC v. Sloan,* 436 U.S. at 118-19. Nevertheless, the Ninth Circuit ignored the fact that MMS has never advanced any legal justification for, or reasoned explanation of, the statutory interpretation of royalty adopted in its orders to Marathon.

Fifth, this Court has also held that a justification of an administrative interpretation of a statute is worthy of deference only if it is articulated by officials acting at the administrative

---

[6] *See, e.g., Chevron,* 467 U.S. at 865 (noting that "the agency considered the matter in a detailed and reasoned fashion"); FEC v. Democratic Senatorial Campaign Committee, 454 U.S. 27, 37 (1981); SEC v. Sloan, 436 U.S. 103, 117-18 (1978).

level with authority to set agency policy; *post hoc* rationalizations developed by trial counsel during the course of litigation are not worthy of deference. *See, e.g., Investment Company Institute v. Camp*, 401 U.S. 617, 626-28 (1971). "It is the administrative official and not appellate counsel who possesses the expertise that can enlighten and rationalize the search for the meaning and intent of Congress." *Id.* at 628. Here the only support for MMS's net-back orders is counsel's *post hoc* rationalization for MMS' interpretation of a portion of the implementing regulation. Neither MMS nor its appellate counsel made any effort to square the net-back orders with the statute.

Finally, this Court has also refused, as a matter of Due Process, to permit a public official or administrative body to adjudicate a final result against a citizen when the agency is biased by its pecuniary interest in the outcome of the decision.[7] In upholding the agency, the Ninth Circuit took no account of MMS' pecuniary interest in the interpretation it advanced. MMS is a collection agency for the Treasury, whose revenues increased directly as a result of an unprecedented interpretation of the term "royalty."

Chevron did not overrule these cases setting forth the degree of judicial deference owed to an agency's statutory interpretation. An inquiry into the circumstances would have revealed that MMS' interpretation was quite unworthy of deference. Because the Ninth Circuit failed to carry out this inquiry it did not properly fulfill its responsibility, to the detriment of Marathon and the industry.

---

[7] *See, e.g.*, Marshall v. Jerrico, 446 U.S. 238, 242-44 (1980); Withrow v. Larkin, 421 U.S. 35, 46-47, 57-58 (1975); Gibson v. Berryhill, 411 U.S. 564, 578-80 (1973) ("those with substantial pecuniary interest in legal proceedings should not adjudicate these disputes"); Ward v. Village of Monroeville, 409 U.S. 57, 60-62 (1972); In re Murchison, 349 U.S. 133, 136 (1955) ("no man can be a judge in his own case and no man is permitted to try cases where he has an interest in the outcome"); Tumey v. Ohio, 273 U.S. 510, 522-23, 532 (1927).

B. This Case Is An Appropriate Vehicle To Instruct The Lower Courts On The Continuing Need To Apply Reliability Criteria To Agency Interpretations As Well As To Correct The Particular Error By The Ninth Circuit.

Once a statute has been deemed ambiguous, most lower courts complacently bow to the agency's interpretation as being "reasonable," without considering whether the agency's interpretation is reliable. The usual result is that when an agency in informal action takes a position on a statute and a private party objects, the courts will accept the agency's position if Congress' language in the statute is imprecise. Revision of agency errors thus becomes possible only through the cumbersome process of legislative amendment.

On the other hand, a few courts have continued to apply this Court's traditional criteria for analyzing the reliability of an agency legal interpretation. *See, e.g., American Federation of Labor v. Donovan,* 757 F.2d 330, 341 (D.C. Cir. 1985) ("when an agency interprets a statute, courts employ, in effect, a sliding scale of deference, taking into account a variety of deference-related factors such as those enumerated in *Batterton v. Francis* [432 U.S. 416 (1977)]"); *but cf.* Starr, *Judicial Review in the Post-Chevron Era,* 3 Yale J. on Reg. 283, 291, 297 (1986) (the author of the *American Federation of Labor* decision argues that *Chevron* cast doubt on the decisions suggesting a sliding scale of review and thus raised "yet unanswered questions about its application"). One instance of a lower court's careful inquiry into the reliability of an agency interpretation after *Chevron* is *Center for Auto Safety v. Ruckelshaus,* 747 F.2d 1, 5-6 (D.C. Cir. 1984), in which the court rejected EPA's approval of General Motors' plan for compliance with the Clean Air Act through design of vehicles with reduced emissions of pollutants to offset vehicles whose emissions violated the Act. After examining various criteria of reliability including agency expertise, the scope of Congress' delegation, and the timing of the agency's interpretation, Judge Scalia concluded:

> The degree of deference appropriate here, therefore, is modest — no more than that thoughtful respect we should give to the views of the officers of another branch who have been officially presented with the issue and who, like us, have taken an oath to apply the law that Congress enacted. That is not enough to overcome what seems to us the clarity of the statutory analysis set forth above.

747 F.2d at 6 (citations omitted); *see also Mayburg v. Secretary,* 740 F.2d 100, 105-06 (1st Cir. 1984) (discussing factors that affect the reliability of agency legal interpretation).

The lower court decisions that continue to examine the reliability of an agency's statutory interpretation are the exception rather than the rule.[8] Most courts assume that all agency legal interpretations are equally reliable, or worse, do what the Ninth Circuit did here, collapse *Chevron's* two-step analysis into one step so that the entire inquiry is directed at one issue only — whether the agency's statutory interpretation was facially "reasonable."[9]

---

[8] Of the more than 250 court of appeals cases specifically relying on *Chevron,* only about 24 attribute any significance to the circumstances justifying deference, and almost all of those cases do so only in passing.

[9] *See, e.g.,* Natural Resources Defense Council v. Thomas, __ F.2d __, Nos. 85-1294, 85-1296, Slip op. at 22, n.20 (D.C. Cir. Nov. 7, 1986) ("Indeed, the apparently separate *Chevron* searches for congressional clarity and agency reasonableness are often collapsible into one; a petitioner will lose on both *Chevron* strands when the agency rebuts a reasonable reading with a reasonable reading of its own."); Simmons v. ICC, 766 F.2d 1177, 1179 n.2 (7th Cir. 1985) (emphasis added) ("recent pronouncements from the Supreme Court indicate that, *without regard to questions of administrative expertise,* the judiciary should, as a matter of course, accord great weight to statutory interpretations rendered by the agency responsible for the statute's enforcement"), *cert. denied,* 106 S. Ct. 791 (1986); Mattox v. FTC, 752 F.2d 116, 123-24 (5th Cir. 1985) (court deemed irrelevant to deference analysis under *Chevron* an aggrieved party's challenge that an agency interpretation did not require agency expertise and that the agency had departed from its prior longstanding policy); Alcaraz v. Block, 746 F.2d 593, 606 (9th Cir. 1984) (collapsing deference analysis under *Chevron* into only one inquiry: whether agency interpretation is within the range of reasonable meanings of the words of the statute).

The instant case provides the Court with a prime opportunity to clarify the second step of the *Chevron* analysis. The Ninth Circuit chose, without analysis or explanation, to defer to the agency's legal interpretation, yet that interpretation is surrounded by circumstances that indicate unreliability. Those circumstances include: (1) congressional intent not to grant the Secretary policymaking authority over the nature of the Government's return from leasing federal lands for oil and gas development; (2) the absence of a technical issue on which the agency had expertise; (3) the inconsistency of the agency's interpretation with its prior rulings; (4) the total lack of any explanation, reasoned or otherwise, of why the agency could collect a net profits interest instead of a royalty; and (5) the pecuniary interest of the agency in the new interpretation it advanced.

In these circumstances, MMS's statutory interpretation deserved close scrutiny. The Ninth Circuit and many other courts, by omitting any analysis of the reliability of the agency interpretation to which they defer, are rubber stamping agency interpretations rather than enforcing congressional mandates.

CONCLUSION

For these reasons, this petition for certiorari should be granted. The Ninth Circuit's decision omits the fundamental first step of statutory analysis under *Chevron* and thus stands as a precedent for allowing an agency to make an unprecedented and erroneous legal interpretation of a statutory term with an accepted commercial usage, contrary to a clear congressional command. Moreover, the Ninth Circuit's decision fails to consider the reliability of the agency's interpretation. Consequently, this Court can, by reviewing this case, clarify an important rule of decision in administrative law on which most of the lower courts are confused or mistaken and which recurs in nearly every case involving judicial review of administrative action.

Dated: December , 1986.

Respectfully submitted,

GIBSON, DUNN &
CRUTCHER

By _____

Charles J. Meyers,
Counsel of Record
A. Randall Farnsworth
Gregory J. Kerwin
Of Counsel:
John A. Carver, Jr.
1801 California Street,
42nd Floor
Denver, Colorado 80202
(303) 298-7200
Attorneys for Petitioner,
Marathon Oil Company

Of Counsel:
D. D. Sandman
G. H. Rothschild, Jr.
K. D. Hinkle

86-1003

Supreme Court, U.S.
FILED
DEC 19 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-

IN THE

Supreme Court of the United States

October Term, 1986

MARATHON OIL COMPANY,
an Ohio corporation,

Petitioner,

v.

UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

GIBSON, DUNN & CRUTCHER
Charles J. Meyers,
Counsel of Record
A. Randall Farnsworth
Gregory J. Kerwin
Of Counsel:
John A. Carver, Jr.
1801 California Street,
42nd Floor
Denver, Colorado 80202
(303) 298-7200
Attorneys for Petitioner,
Marathon Oil Company

Of Counsel:
D. D. Sandman
G. H. Rothschild, Jr.
K. D. Hinkle

TABLE OF CONTENTS

		Page
A.	Ninth Circuit Opinion and Judgment Issued July 24, 1986	2a
B.	District Court Orders	18a
	1. District Court Order and Injunction Issued May 1, 1985	18a
	2. District Court Opinion and Order Issued February 20, 1985	22a
C.	Agency Orders, Instructions and Notice	54a
	1. Interior Department Assistant Secretary's Order Issued June 11, 1984	54a
	2. Minerals Management Service Order Issued October 5, 1983	57a
	3. Minerals Management Service Order Issued July 8, 1983	61a
	4. Minerals Management Service Instructions Issued February 28, 1983	64a
	5. Minerals Management Service Notice Issued January 6, 1983	71a
D.	Orders Concerning Rehearing	75a
	1. Ninth Circuit Order Issued July 25, 1986	75a
	2. Ninth Circuit Order Issued August 20, 1986	76a
	3. Ninth Circuit Order Issued September 3, 1986	78a
	4. Ninth Circuit Order Issued September 30, 1986	79a
	5. Ninth Circuit Order Issued September 30, 1986	80a
	6. Ninth Circuit Order Issued November 13, 1986	81a

No. 86-

IN THE

Supreme Court of the United States

October Term, 1986

MARATHON OIL COMPANY,
an Ohio corporation,

Petitioner,

v.

UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

A. NINTH CIRCUIT OPINION AND JUDGMENT ISSUED JULY 24, 1986

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, an Ohio corporation, *Plaintiff-Appellant,*	No. 85-3800 DC. No. A83-208 Civil
vs.	
UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation, *Defendants-Appellees.*	
COOK INLET REGION, INC., an Alaska corporation, *Counterclaimant,*	
vs.	OPINION
MARATHON OIL COMPANY, an Ohio corporation, *Counterdefendant.*	

Appeal from the United States District Court
for the District of Alaska
James M. Fitzgerald, District Judge, Presiding
Argued and Submitted February 14, 1986
Seattle, Washington

Before: WRIGHT and WALLACE, Circuit Judges,
and LEGGE,* District Judge.

---

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

WALLACE, Circuit Judge:

Marathon Oil Company (Marathon) appeals from the district court's dismissal of its claims and from the entry of summary judgment and an injunction on the government's counterclaim that required it to pay production royalties on federal oil and gas leases based on a net back valuation formula. We have jurisdiction pursuant to 28 U.S.C. § 1292(a)(1), and we affirm.

I

Marathon owns a 50% working interest in certain federal oil and gas leases in the Kenai Field Unit in Alaska. The leases require Marathon to pay 12½% royalty on the reasonable value of production from the leased lands "computed in accordance with the Oil and Gas Operating Regulations (30 C.F.R. Pt. 221) [now codified in relevant part at 30 C.F.R. § 206.103 (1985)]." The statutory authorization for promulgating the Oil and Gas Operating Regulations is found at 30 U.S.C. § 226(c). The government, the State of Alaska, and Cook Inlet Region, Inc. (Cook Inlet) are each entitled to receive a percentage of the royalties. Marathon transports about 16% of its share of the gas produced in the Kenai Field Unit to a liquefied natural gas plant owned by Marathon and Phillips Petroleum Company. After the gas is reduced to a liquid state, Marathon transports the liquefied natural gas in tankers to Japan where it is sold. Marathon computed royalties on the liquefied natural gas sold in Japan based on the price paid for Kenai Field Unit gas under a long-term contract it had to sell unliquefied gas to the Alaska Pipeline Company.

In 1977, the United States Geological Survey (USGS), which was responsible for managing federal oil and gas leases, concluded that the royalty value for the liquefied natural gas sold in Japan should reflect its sales price in Japan less expenses. Marathon objected to USGS's proposed net back

valuation formula. In an effort to resolve the dispute, an agreement was entered into that required Marathon to pay royalties as computed according to the "Phillips formula." The Phillips formula required Marathon to pay royalties based on 36% of the price received in Japan for the liquefied natural gas, less certain adjustments. The agreement was to remain in effect until market conditions changed or applicable laws necessitated revision of the valuation method.

In 1983, the Mineral Management Service (the Service), which succeeded USGS as the government agency responsible for managing the involved leases, notified Marathon that it intended to redetermine the reasonable value of production of the Kenai gas delivered to the liquefied natural gas plant. The Service told Marathon that the basic net back approach as incorporated into the Phillips formula was sound, but that certain adjustments needed to be made to reflect current costs and prices. The new royalty valuation formula required subtraction of certain actual costs, instead of a fixed percentage, from the sales price of the liquefied natural gas.

Although it was not required to do so by statute, the Service held a public hearing at which Marathon appeared and was permitted to make comments, to state opinions, and to provide statements of facts concerning the new royalty valuation formula. The Service designated a 30-day period following the hearing for comments in which all interested parties could provide additional information or make additional arguments in favor of their position. After the 30-day period expired, the Service issued an order directing Marathon to pay royalties based on the revised royalty valuation formula. Marathon appealed the order to the Director of the Service, alleging that the Service had repudiated the settlement agreement entered into by Marathon and USGS. In addition, Marathon ceased paying royalties based on the agreed-to Phillips formula and began computing royalties based on the long-term contract price paid to the Alaska Pipeline Company.

The Service issued a second order directing Marathon to compute royalties according to the Phillips formula from the date Marathon began computing royalties based on the terms of the long-term contract to the effective date of the order requiring compliance with the revised royalty valuation formula. Marathon did not comply with this second order either. The Department of the Interior (the Department) then issued a third order, at the direction of the Secretary of the Interior (the Secretary), directing Marathon to comply with the previous two orders.

Marathon filed a declaratory relief action, 28 U.S.C. § 2201, in district court seeking, among other things, a determination of the proper method of valuing the royalty for natural gas which was liquefied and sold in Japan. The government sought to have Marathon's claims dismissed and counterclaimed to enforce the previous orders and to recover unpaid royalties. The government requested a preliminary injunction to compel Marathon to comply with the Service's orders, and moved for summary judgment. The district court deferred ruling on the government's request for a preliminary injunction until the motion for summary judgment was heard. The district court then granted the government's motion for summary judgment on its counterclaim, dismissed Marathon's claims and issued an injunction ordering Marathon to comply with the orders. The district court retained jurisdiction, however, until an accounting to determine royalties due from Marathon had been completed. A more extensive statement of the facts appears in the district court opinion, *see Marathon Oil Co. v. United States*, 604 F. Supp. 1375, 1376-78 (D. Alaska 1985) (*Marathon*).

II

Marathon's complaint requested a declaratory judgment to the proper method of valuing production for royalty purposes. The Declaratory Judgment Act, 28 U.S.C. § 2201, however, does not create an independent jurisdictional basis for actions

in federal court. *See Fiedler v. Clark*, 714 F.2d 77, 79 (9th Cir. 1983) (per curiam); *Alton Box Board Co. v. Esprit de Corp.*, 682 F.2d 1267, 1274 (9th Cir. 1982). Therefore, we must decide whether the administrative orders that required Marathon to pay production royalties based on the net back valuation formula were final agency actions reviewable by the district court pursuant to the jurisdictional grant of section 10(c) of the Administrative Procedures Act, 5 U.S.C. § 704. *See FTC v. Standard Oil Co.*, 449 U.S. 232, 238 (1980).

The Supreme Court has instructed us to interpret "pragmatically the requirement of administrative finality, focusing on whether judicial review at the time will disrupt the administrative process." *Bell v. New Jersey*, 461 U.S. 773, 779 (1983). The third order issued by the Department, which required Marathon to comply with the previous two orders issued by the Service, contained the following language: "This order is issued at the direction of the Secretary and, accordingly, constitutes a final decision by the Department pursuant to 43 C.F.R. Section 4.5(a)." Section 4.5(a) indicates that the Secretary retains the power to take jurisdiction "at any stage of any case before any employee or employees of the Department . . . and render the final decision in the matter." 43 C.F.R. § 4.5(a) (1985). The Secretary exercised this power and issued a final decision that required Marathon to comply with the previous two orders. Therefore, the district court had jursidiction [sic] pursuant to section 10(c) of the Administrative Procedures Act to act on Marathon's claim for declaratory judgment and to decide the validity of the orders.

III

That does not answer the question, however, of whether we have jurisdiction to review the district court's entry of summary judgment, partial dismissal and injunction. Section 1292(a)(1) provides us with jurisdiction to review "inter-

locutory orders of the district courts of the United States . . . granting . . . injunctions." After concluding that the Service's orders were appropriate and that the government was entitled to summary judgment and dismissal of Marathon's claims as a matter of law, the district judge issued an injunction that required Marathon to comply with the orders. The entry of summary judgment and partial dismissal, however, was not a final judgment within the meaning of 28 U.S.C. § 1291 because the district court retained jurisdiction to conduct an accounting. *See Warehouse Restaurant, Inc. v. Customs House Restaurant, Inc.*, 726 F.2d 480, 481 (9th Cir. 1984); *Hain Pure Food Co. v. Sona Food Products Co.*, 618 F.2d 521, 522 (9th Cir. 1980) (per curiam). Therefore, the injunction, although permanent in nature, is an interlocutory order appealable under section 1292(a)(1). *See Smith v. Eggar*, 655 F.2d 181, 184-85 (9th Cir. 1981); *Ackerman-Chillingworth, Division of Marsh & McLennan, Inc. v. Pacific Electrical Contractors Association*, 579 F.2d 484, 489 (9th Cir. 1978), *cert. denied*, 439 U.S. 1089 (1979); 16 C. Wright, A. Miller, E. Cooper & E. Gressman, *Federal Practice and Procedure* § 3924, at 67-68 (1977).

Although we have jurisdiction to review the issuance of the injunction, we must also consider whether we have jurisdiction to review the summary judgment and partial dismissal. Marathon contends that we may do so based on the jurisdictional grant of section 1292(a)(1). "[A]n order granting or refusing an injunction brings before the appellate court the entire order, not merely the propriety of injunctive relief, and [we] may decide the merits of the case and order dismissal of the action." *Barrett v. Smith*, 530 F.2d 829, 830 (9th Cir. 1975) (per curiam) (citation omitted), *cert. denied*, 425 U.S. 977 (1976). As a general rule, however, we concern ourselves "only with the order from which the appeal is taken, " *Yamamoto v. Omiya*, 564 F.2d 1319, 1325 n.11 (9th Cir. 1977), and review other issues only if they are "inextricably bound up" with the injunction. *Phoceene Sous-Marine, S.A. v. U.S. Phosmarine,*

Inc., 682 F.2d 802, 805 (9th Cir. 1982); *see Fentron Industries, Inc. v. National Shopmen Pension Fund*, 674 F.2d 1300, 1304 (9th Cir. 1982) (*Fentron*) (review of injunction necessarily involved deciding substantive issues).

In *Smith v. Vulcan Iron Works*, 165 U.S. 518 (1897) (*Smith*), the Supreme Court entertained a like jurisdictional challenge under very similar facts. In *Smith*, the district court entered an interlocutory judgment that a patent was valid, issued an injunction to prohibit infringement of the patent, and referred the case to a master to make an accounting of damages and profits. The defendant appealed, claiming that the patent was invalid and that it had not been infringed. The plaintiff moved to limit consideration on appeal to the propriety of the injunction. We concluded that the patent was invalid, that it had not been infringed, and reversed the interlocutory judgment of the district court. *Id.* at 518. The plaintiff contended before the Supreme Court that we erred in deciding the merits based on a jurisdictional grant to review the propriety of the injunction. The Court, however, concluded that the appeal from the interlocutory permanent injunction permitted us to decide the case upon its merits. *Id.* at 525. We have reached the same conclusion on a number of occasions. *See, e.g., Fentron*, 674 F.2d at 1304; *Long v. Bureau of Economic Analysis*, 646 F.2d 1310, 1317-18 (9th Cir.) (per curiam), *vacated on other grounds*, 454 U.S. 934 (1981).

Although we have expressed reluctance to review a denial of summary judgment when reviewing a preliminary injunction, *see Sierra On-Line, Inc. v. Phoenix Software, Inc.*, 739 F.2d 1415, 1421 (9th Cir. 1984), due in part to the fact that our review of a preliminary injunction is necessarily limited, *see Sports Form, Inc. v. United Press International, Inc.*, 686 F.2d 750, 752-53 (9th Cir. 1982), we see no need to refrain from determining the validity of the orders in this case. The injunction here is a permanent rather than a temporary in-

junction. The legality and enforceability of the orders is inextricably bound up with the injunction that requires Marathon to comply with the orders. The district court has completed its consideration of the liability issue, retaining jurisdiction only for an accounting of damages. We conclude, therefore, that we have jurisdiction pursuant to section 1292(a)(1) to review the summary judgment and partial dismissal and that we should do so in this case.

IV

Marathon contends that the district judge erred in granting the government's motion for summary judgment and the resultant dismissal of Marathon's claims because the net back valuation formula adopted by the Service is contrary to the Mineral Lands Leasing Act, 30 U.S.C. §§ 181-287 (the Act), to the regulations and rulings issued pursuant to the Act, and to the terms of Marathon's leases. Marathon does not challenge the propriety of the injunction other than to argue that it was improper because it is based upon a wrongly decided summary judgment. Therefore, we need address only the correctness of the district court's entry of summary judgment.

We review the district judge's entry of summary judgment de novo and will affirm if, after reviewing the record in the light most favorable to the non-moving party, there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. *See Continental Casualty Co. v. City of Richmond,* 763 F.2d 1076, 1078-79 (9th Cir. 1985); *Nevada v. United States,* 731 F.2d 633, 635 (9th Cir. 1984).

The fact that we review the summary judgment de novo, however, does not mean that we review de novo the Service's decision to adopt the net back valuation formula and to issue the compliance orders. *See Cranston v. Clark,* 767 F.2d 1319, 1320 (9th Cir. 1985); *Kidd v. Department of Interior, Bureau of Land Management,* 756 F.2d 1410, 1411-12 (9th Cir. 1985).

De novo review in this case means only that we view the case from the same position as the district court. In section 10(e) of the Administrative Procedures Act, 5 U.S.C. § 706, Congress established a deferential standard of review of agency decisions. This is especially true where, as here, the agency action being reviewed is not pursuant to agency rule making authority, 5 U.S.C. § 553, or action based on a public adjudication hearing, 5 U.S.C. §§ 556, 557. In the case before us, the informal agency decision in issue will not be reversed unless it is determined to be arbitrary, capricious, an abuse of discretion, or contrary to law. 5 U.S.C. § 706(2)(A); *see Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 413-14 (1971) (*Overton Park*). We must determine only whether a clear error of judgment has occurred and whether the agency based its decision upon consideration of relevant factors. *See Overton Park*, 401 U.S. at 416. Thus, we do not review the Service's decision to adopt the net back formula under the substantial evidence standard of section 706(2)(E) because the Service did not engage in rulemaking or base its decision on a public adjudicatory hearing. *Id.* at 414.

The agency's interpretation of the applicable statute is entitled to substantial deference, particularly if the agency is charged with administering the statutes. *See Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984). Furthermore, an agency's interpretation of its regulations is " 'of controlling weight unless it is plainly erroneous or inconsistent with the regulation[s].' " *Udall v. Tallman*, 380 U.S. 1, 16-17 (1965), *quoting Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945); *see Hawaiian Electric Co. v. EPA*, 723 F.2d 1440, 1447 (9th Cir. 1984).

A.

We have reviewed the district judge's well-reasoned opinion in this case. *See Marathon*, 604 F. Supp. 1375. The district judge applied the appropriate standard of review and concluded as a matter of law that the net back valuation formula

did not violate the Act, that the formula was not contrary to agency regulations or rulings, and that the formula was not inconsistent with the terms of Marathon's leases. We agree. This is not the first time we have concluded that it is not unreasonable for the Secretary to use a net back or net realization formula to compute the value of production for royalty purposes. *See Continental Oil Co. v. United States,* 184 F.2d 802, 820-21 (9th Cir. 1950); *see also Ashland Oil, Inc. v. Phillips Petroleum Co.,* 554 F.2d 381, 387-88 (10th Cir. 1977) (en banc) (government has often used a work back method to determine royalties due), *cert. denied,* 434 U.S. 921 and 434 U.S. 968 (1977); R. Hemingway, *The Law of Oil and Gas* § 7.4, at 355 (1983) (proceeds language requires royalty computation based on sales price rather than market or field price). For the reasons so ably expressed by the district judge in discussing the issues before him, *Marathon,* 604 F. Supp. at 1380-90, we conclude that he did not err in upholding the validity of the net back valuation formula used in this case.

B.

Marathon has raised several additional arguments not addressed by the district judge. Marathon contends that the net back valuation formula is contrary to previous agency rulings. The district judge held that the Duletsky memorandum and the royalty payment order to Union Oil Company do not preclude application of the net back valuation formula. *See* 604 F. Supp. at 1383-84, 1389. In addition, however, Marathon contends, that the Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5) demonstrates that a net back formula is contrary to agency regulations. Although Marathon relied on NTL-5 to support its position in the district court, the district judge did not specifically refer to it in his opinion. Consequently, we now consider the significance of NTL-5 to this case.

Section V.C. of NTL-5 states that "[r]oyalty generally will be computed on the volume and value of marketable production at the lease, communitized area, or unit participating area

boundary." Marathon relies on this language to argue that the value of production for royalty purposes should be determined at the well site. Such an argument, however, ignores critical language in section V.A., which states that "[u]nder no circumstances will royalty be computed on less than the gross proceeds accruing to the lessee or operator from the sale of leasehold production." Similar references to "the price received by the lessees" for the gas produced can be found in sections I.A.1 and II.B.1. We conclude that the implicit exception in section V.C. created by the word "generally" becomes operative when the use of the wellhead price to calculate royalties would result in a royalty being computed on less than the gross proceeds received by the lessee from the sale of the produced gas. Thus, the net back valuation formula does not conflict with language of NTL-5.

Marathon also argued before the district court and contends before us that the net back valuation formula fails to consider all of the costs incurred in manufacturing and selling liquefied natural gas and that the potential imposition of an 8% reasonable rate of return is arbitrary and unjust. We conclude that these issues are not ripe for judicial review. The district court retained jurisdiction to conduct an accounting in order to determine the royalties due from Marathon. *Marathon,* 604 F. Supp. at 1390. Marathon has filed an accounting with the district court that raises a number of these same issues. The Service has reviewed Marathon's accounting and filed objections to the calculation procedures and factors used by Marathon to complete the accounting. The government and Cook Inlet contend that review of the accounting aspects of the net back valuation formula is premature and that we should wait until the district court has had an opportunity to prepare a more complete record. Because many of these same objections are presently being considered by the district court and because the factual record on these issues is not well developed, we decline to consider the merits of Marathon's objections to the specifics of the net back valuation formula at this time.

C.

Marathon also contends that the district judge erred in granting the government's motion for summary judgment because there are genuine issues of material fact as to whether natural gas and liquefied natural gas are substantially similar, whether the Service waived administration of one of the involved leases held by Cook Inlet, and whether Cook Inlet improperly influenced the Service's decision to adopt the net back valuation formula.

1.

The district court concluded that liquefied natural gas is not "distinct from the natural gas at the wellhead" but rather "is natural gas that has been cooled for purposes of storage or shipment." 604 F. Supp. at 1386. Marathon contends that the district judge's determination that liquefied natural gas is essentially the same as natural gas required him to resolve disputed issues of material fact. We do not decide this issue because it was unnecessary for the district judge to make a finding of fact concerning the nature of liquefied natural gas. The deferential standard of review of informal agency decisionmaking requires only that we "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Overton Park*, 401 U.S. at 416.

Marathon first argued that liquefied natural gas is a manufactured product separate from natural gas in response to the USGS's request for information concerning the gross proceeds received from the sale of the liquefied natural gas in Japan. The USGS's incorporation of a net back approach into the Phillips formula and the Service's subsequent adoption of a net back formula based on certain actual costs represent a clear rejection of Marathon's argument. Although our examination

of the facts in the administrative record "is to be searching and careful," we are not "empowered to substitute [our] judgment for that of the agency," *id.*

Whether liquefied natural gas is different from natural gas is not before us and was not properly before the district court. Reviewing the informal agency decision in this case does not require us to consider whether there was substantial evidence in the record regarding the nature of liquefied natural gas. On the actual issue before us — the reasonableness of the Secretary's net back formula, *see id.*, Marathon has not pointed to any relevant factors that the Service failed to consider prior to issuing the order. Furthermore, we do not conclude that the Service clearly erred in adopting a net back valuation formula to determine royalties due on Marathon's sale of liquefied natural gas.

2.

Marathon also contends that a genuine issue of material fact exists as to whether the Service waived authority to administer one of the leases in the Kenai Field Unit conveyed to Cook Inlet by the government. Marathon relies on a letter the Service delivered to Union Oil Company and on an agency regulation, 43 C.F.R. § 2650.4-3 (1985), to contend that the Service has waived administration of the lease. The regulation provides that "administration shall be waived when the conveyance covers all the land embraced within a lease . . . unless there is a finding by the Secretary that the interest of the United States requires continuance of the administration by the United States." *Id.* There was no need for the district court to decide whether the waiver occurred because the issue was not properly preserved. Marathon failed to raise this issue during the public hearing or during the 30-day comment period or in its appeal from the initial order.

As a general rule, we will not consider issues not presented before an administrative proceeding at the appropriate time. *See Reid v. Engen*, 765 F.2d 1457, 1460 (9th Cir. 1985)

(*Reid*); *Inter-Tribal Council v. Department of Labor,* 701 F.2d 770, 771 (9th Cir. 1983) (per curiam). We have recognized, however, a number of exceptions to the general rule. "We may decide an issue not raised in an agency action if the agency lacked either the power or the jurisdiction to decide it." *Reid,* 765 F.2d at 1461; *see Reese Sales Co. v. Hardin,* 458 F.2d 183, 187 (9th Cir. 1972). This type of issue typically implicates the constitutionality of a statute or regulation where the agency does not have power to correct a claimed grievance. *Reid,* 765 F.2d at 1461; *see, e.g., Bagues-Valles v. INS,* 779 F.2d 483, 484 (9th Cir. 1985). Marathon's contention that the Service waived authority to administer one of the leases in the Kenai Field Unit does not involve a constitutional question, suggest that agency power or jurisdiction to decide the issue was lacking, or suggest that the Service was foreclosed from responding to its claim. Therefore, this exception to the rule of administrative exhaustion is inapplicable here.

Another exception permits us to "decide issues over which an agency has power and jurisdiction when 'exceptional circumstances' warrant such review, notwithstanding the petitioner's failure to present them to the agency." *Reid,* 765 F.2d at 1461; *see Page v. Donovan,* 727 F.2d 866, 868 (9th Cir. 1984); *Getty Oil Co. v. Andrus,* 607 F.2d 253, 255-56 (9th Cir. 1979). We have previously distinguished between administrative exhaustion requirements that are based on a statutory directive and those that are judicially imposed. *Reid,* 765 F.2d at 1462; *Montgomery v. Rumsfeld,* 572 F.2d 250, 252-53 (9th Cir. 1978) (*Montgomery*). Statutory exhaustion requirements implicate concerns of separation of powers and, therefore, the failure to comply with the requirements deprives us of jurisdiction. *Reid,* 765 F.2d at 1462; *Montgomery,* 572 F.2d at 252-53. We are unaware of any statutory exhaustion requirements that apply here. Thus, we may review Marathon's contention that the Service waived authority to administer one of the leases if exceptional circumstances exist.

In determining whether exceptional circumstances exist, we balance "the agency's interests 'in applying its expertise, correcting its own errors, making a proper record, enjoying appropriate independence of decision and maintaining an administrative process free from deliberate flouting, and the interests of private parties in finding adequate redress for their grievances.'" *Litton Industries, Inc. v. FTC,* 676 F.2d 364, 369-70 (9th Cir. 1982), *quoting Montgomery,* 572 F.2d at 253. Marathon presents us with no reasons why it did not raise the questions it had concerning the alleged waiver during the agency proceedings. Marathon's failure to raise the issue precluded the Service from interpreting its own regulation, particularly with respect to the timeliness, form, and other requirements of the Secretary's finding. *See Reid,* 765 F.2d at 1462. After balancing the relevant interests, we conclude that Marathon has waived this argument by failing to raise it at the agency level. Marathon has provided us with no evidence of exceptional circumstances that would warrant consideration of this contention. *See Duncanson-Harrelson Co. v. Director, Office of Workers' Compensation Programs,* 644 F.2d 827, 832 (9th Cir. 1981).

3.

Marathon also argues that there is a genuine issue of material fact concerning whether Cook Inlet improperly influenced the Service's decision to adopt the net back valuation formula. Marathon contends that private negotiations memorialized in a Memorandum of Understanding (MOU II) show that improper influence occurred. The district judge, however, concluded that since the order requiring compliance with the net back valuation formula was issued one month in advance of MOU II, Marathon's general allegations of impropriety failed to provide factual support for its theory of inappropriate and illegal negotiations. 604 F. Supp. at 1387-88; *see Burglin v. Morton,* 527 F.2d 486, 489 (9th Cir. 1975), *cert. denied,* 425 U.S. 973 (1976). We agree.

Consequently, no genuine issue of material fact remained to prevent the district judge from granting the government's motion for summary judgment. *See Kung v. FOM Investment Corp.*, 563 F.2d 1316, 1318 (9th Cir. 1977) (per curiam); *California v. Department of Transportation*, 561 F.2d 731, 733 n.4 (9th Cir. 1977).

AFFIRMED.

B. DISTRICT COURT ORDERS

1. District Court Order and Injunction Issued May 1, 1985.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ALASKA

MARATHON OIL COMPANY,	)	
Plaintiff,	)	
v.	)	No. A83-208 Civil
UNITED STATES OF AMERICA, *et al.*	)	
Defendants.	)	

ORDER

For the reasons stated in the opinion in this action issued and filed by the Court on February 20, 1985, including the findings of fact and conclusions of law set forth therein, IT IS HEREBY ORDERED that:

1. Federal Defendants' Motion for Summary Judgment and Partial Dismissal, filed in this Court on December 17, 1984, is granted, and the administrative orders issued to Marathon Oil Company by the Department of the Interior on July 8, 1983, October 5, 1983, and June 11, 1984 are upheld as valid.

2. Marathon Oil Company's claims against the Federal Defendants are dismissed.

3. Marathon Oil Company's Motion for Preliminary Injunction and Judicial Stay of Administrative Action, filed in this Court on November 5, 1984, is denied.

4. The Federal Defendants are entitled to an injunction, and accordingly Marathon Oil Company is re-

quired to calculate and pay royalties on the natural gas produced from its Kenai Unit leases, liquefied at its LNG facility in Nikiski, and sold in Japan, in accordance with the Department of the Interior letters dated January 6, 1983, February 28, July 8, 1983, October 5, 1983 and June 11, 1984. Copies of those letters are attached hereto as Exhibits A through E and made a part of this Order. The payment hereby required shall be made in the time and manner required by paragraph 5 below.

5(a). Marathon Oil Company is required to conduct an accounting to determine the amount of royalties due for the period between April 1, 1983 and July 31, 1983, based upon the "Phillips Formula" referred to in the letter order of October 5, 1983, and to conduct an accounting to determine the amount of royalties due since August 1, 1983, calculated under the methodology prescribed in the Department of the Interior letters dated January 6, 1983 and February 28, 1983, including interest thereon to the date of payment computed in accordance with the interest rate provisions of 30 U.S.C. § 1721(a). Such an accounting shall be filed with the Court and served on the parties no later than 45 days from the date of this Order. At the time of filing such accounting, Marathon shall make payment to the Federal Defendants of the additional royalty amounts and interest determined to be owing based upon the accounting.

(b). By that same date, Marathon shall make available to the Federal Defendants all supporting information and documentation used to prepare the accounting and such other relevant information as is necessary to review the accounting. Within 60 days of receipt of the above-required accounting, the Federal Defendants shall formally accept or object in writing to the accounting. If the Federal Defendants object to the accounting, Marathon is required, within 20 days of receipt of those objections to make any additional royalty and interest payments required by the accounting and any objections; Marathon

also shall begin to make its regular monthly payments as required by the accounting and any objections. At the time Marathon makes any such additional payment it shall file with the Court and serve upon the federal defendants a written response to the Federal Defendants' objections to the accounting. Within 20 days after receipt of Marathon's response and payment, Federal Defendants shall file with the Court and serve upon Marathon their final determination with respect to the accounting and royalty value.

6. Upon Marathon's submission of the accounting and payments required by paragraph 5, Marathon shall be deemed to have complied with this injunction.

7. Enforcement of the injunction granted herein shall be stayed for a period of ten days from the date of this Order to enable Marathon to apply to the Court of Appeals for a stay pending appeal.

8. In the event that objections to Marathon's accounting are filed by Federal Defendants, and Marathon disagrees with those objections and Federal Defendants' final determination, the Court will conduct further proceedings. The Court retains jurisdiction to conduct such proceedings, if necessary, to enter judgment in favor of the United States for the amounts ascertained to be owing by Marathon and to determine any remaining matters.

MADE AND ENTERED at Anchorage, Alaska, this 1st day of May, 1985.

/s/ JAMES M. FITZGERALD

James M. Fitzgerald
United States District Judge

APPROVED AS TO FORM:

RICHMOND & ASSOCIATES,
a Professional Corporation

/s/ DANIEL T. QUINN

Robert L. Richmond
Daniel T. Quinn

Attorneys for Plaintiff
and Counterdefendant
Marathon Oil Company

[The MMS Orders, attached to the District Court order as exhibits are omitted here but are reproduced at Appendix C.]

2. District Court Opinion and Order Issued February 20, 1985.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ALASKA

MARATHON OIL COMPANY, *Plaintiff,* v. UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation, *Defendants.*	No. 85-3800 A83-208 Civil
COOK INLET REGION, INC., an Alaska Corporation, *Counterclaimant,* v. MARATHON OIL COMPANY, an Ohio corporation, *Counterdefendant.*	

JAMES M. FITZGERALD, Chief Judge.

Plaintiff Marathon Oil Company owns an undivided fifty percent working interest in certain oil and gas leases in the Kenai Field Unit in Alaska. Marathon and its working interest associate, Union Oil Company of California, discovered natural gas in the Kenai field in 1959, and production commenced in 1961.

During 1982, a representative year, the production of the Kenai field was delivered to a number of different purchasers. Approximately 16% was delivered to a liquefied natural gas (LNG) plant at Nikisi [sic], Alaska owned by Marathon and Phillips Petroleum Company. Over 42% of Kenai field gas was delivered to an ammonia and urea plant at Mikisi [sic] owned by Collier Chemical Company, a subsidiary of Union Oil Company. Over 31% of production was sold to Alaska Pipeline Company under a long-term contract for distribution in the Anchorage market. About 9% of the gas was rented to the Swanson River Field Unit for pressure maintenance. A small portion of the gas was sold under contract to the City of Kenai, and a portion was used in production operations in the Kenai field.

Each of the defendants, the United States, the State of Alaska, and Cook Inlet Region, Inc. (CIRI), is entitled to receive royalties on gas produced in the Kenai field. There are both federal leases and state leases in the Kenai field. The leases are of four types: (a) leases which were originally federal leases covering lands later conveyed to the state pursuant to the Statehood Act;[1] (b) leases which were originally federal leases covering lands later conveyed to CIRI pursuant to the Alaska Native Claims Settlement Act (ANCSA);[2] (c) federal leases covering lands currently held by the United States; and (d) state leases covering lands currently held by the state. All of the federal leases provide that Marathon shall pay 12½% royalty on the reasonable value of production from the leased lands. Alaska does not directly receive royalties from production attributable to the federal leases. However, under a provision of the Mineral Lands Leasing Act,[3] Alaska is entitled to 90% of all royalties received by the United States from oil and gas production on federal lands in the Kenai field.

---

[1] Pub. L. No. 85-508, 72 Stat. 339 (1958).
[2] 43 U.S.C. §§ 1601-1628 (1982).
[3] 30 U.S.C. § 191 (1982).

A dispute arose in 1977 between Marathon and the United States Geological Survey (USGS)[4] as to the proper method of computing the reasonable value, for royalty purposes, of that part of gas production from federal leases delivered to the LNG plant. Gas delivered to the plant is cooled through a multi-step cooling process to transform it into a liquid. The liquefied natural gas (LNG) is then transported by tanker to Japan where it is sold to two utility companies. Marathon had been computing royalties on this gas on the basis of the price paid for Kenai field gas under the long-term contract with Alaska Pipeline Company. In 1977 USGS took the position that royalty value was to be established on the basis of the sales price for LNG in Japan less expenses.[5]

To resolve the dispute, Marathon and the USGS entered into an agreement on February 6, 1981, retroactive to January 1, 1980.[6] The settlement agreement provided that royalties were to be computed using the "Phillips formula" which had been developed for use by Phillips Petroleum Co. in computing royalties due the state of Alaska under state leases for gas delivered to the LNG plant at Nikisi [sic]. Under the Phillips formula, Marathon was to pay royalties based on 36% of the per MMbtu price received in Japan for the LNG (less certain adjustments). In addition, Marathon paid USGS $1,834,160.83 representing additional royalties due from January 1, 1980 through February 1981. The settlement agreement was, by its terms, effective "until such time as changes in market conditions, State or Federal law, or regulations adopted thereunder . . . necessitate a revision in the method used to determine the wellhead value."[7]

---

[4] The responsibility for management of federal oil and gas leases is now held by the Minerals Management Service (MMS) of the Department of the Interior (DOI).

[5] Letter of Oct. 31, 1977 from Rodney A. Smith, USGS, to John R. South, Marathon Oil Co., Administrative Record (A.R.) 100.

[6] Letter of February 6, 1981 from James P. Murphy, Marathon Oil Co., to Barry A. Boudreau, USGS, A.R. 145.

[7] *Id.* at 3.

On January 6, 1983, the Minerals Management Service (MMS) notified Marathon of MMS's intention to redetermine the reasonable value for computing royalties on gas delivered to the LNG plant.[8] The letter stated that the basic net back valuation theory by which the reasonable wellhead value was derived from the sales price in Japan was sound, but that adjustments were necessary to reflect changing costs and prices due to economic conditions. MMS proposed to update the coefficients in the Phillips formula to reflect current processing and transportation costs.

The letter also informed Marathon that MMS would hold a public hearing on the matter in Anchorage, and that Marathon had thirty days to file written comments, evidence, and legal argument. Moreover, Marathon would have an opportunity at the hearing to present its views to MMS. A public hearing was held in Anchorage on March 1, 1983, and at that time Marathon appeared and offered information on its own behalf.[9]

Based on the hearing, written comments, and other materials, MMS on July 8, 1983 issued an order to Marathon directing the company to begin paying royalties as of August 1, 1983 based on the revised computations.[10] Marathon did not comply but filed an appeal of the July 8 order. In substance, Marathon disputed MMS's authority to redetermine the royalty basis, claiming that by notifying Marathon of the intended change in computation, MMS had repudiated the settlement agreement based on the Phillips formula. Moreover, effective April 1, 1983, Marathon unilaterally rolled back the basis on which royalties on gas delivered to the LNG plant were computed to presettlement rates. That is, rather than following

---

[8] Letter of Jan. 6, 1983 from Robert E. Boldt, MMS, to Al Mechler, Jr., Marathon Oil Co., A.R. 47.

[9] *See* A.R. 39.

[10] Letter of July 8, 1983 from William H. Feldmiller, MMS, to Curtis Dowden, Marathon Oil Co., A.R. 8.

the formula of 36% of the price received in Japan, which had been in effect since January 1980, Marathon began to compute royalties based on the long-term contract price paid by Alaska Pipeline Company for Kenai field gas.

Under the July 8, 1983 order of MMS, Marathon was required for royalty purposes to compute the value for gas delivered to the LNG plant at $3.00/Mcf. By the terms of the settlement agreement based on sales of LNG in Japan, Marathon in the period immediately prior to April 1, 1983 computed the value of gas for royalty purposes at $1.71/Mcf. After that date, Marathon computed the value of gas at $.61/Mcf based on the contract price for Kenai field gas paid by Alaska Pipeline Company.

After MMS learned Marathon had unilaterally rolled back the price effective April 1, 1983, the agency issued a second order, dated October 5, 1983, directing Marathon to compute the value of gas for royalty purposes under the settlement or Phillips' formula for the months of April through July 1983.[11] Once again, Marathon did not comply with the MMS order. Finally, on June 11, 1984, the Department of the Interior (DOI) issued a third order directing Marathon to comply with the previous orders of MMS.[12]

Marathon filed a complaint in this court on April 14, 1983 challenging the revised valuation method proposed by MMS. The original complaint has been amended to challenge the three DOI orders issued after the complaint was filed.[13] In its

---

[11] Letter of Oct. 5, 1983 from Milton K. Dial, MMS, to D.J. Durham, Union Oil Co. (as agent for Marathon Oil Co.), A.R. 9.

[12] Letter of June 11, 1984 from Assistant Secretary for Land and Minerals Management, Department of the Interior, to William F. Swales, Marathon Oil Co., and Ray A. Burke, Union Oil of California, A.R. 11.

[13] Marathon amended its complaint on October 7, 1983, and again on September 4, 1984.

amended complaint, Marathon now seeks declaratory relief to resolve the actual controversy among the parties involving the proper method of determining the wellhead value of the natural gas for royalty purposes. Apart from that, Marathon seeks redress for breach of lease provisions, for an accounting, for restitution, and to secure Marathon's rights under the United States Constitution and the Alaska Constitution.

The federal government in answer to the amended complaint denies that Marathon is entitled to relief for any of its claims and seeks to have the claims dismissed. In a counterclaim, the federal government contends that effective August 1, 1983, Marathon was required to compute royalties on production delivered to the LNG plant in accordance with the MMS orders. Under those orders, the reasonable value of gas at the wellhead is deemed to be $3.00/Mcf, as opposed to the $.61/Mcf value used by Marathon since April 1983. Moreover, the government requests that Marathon be required to pay $717,705 as unpaid royalties on production for the period from April through July 1983 computed using the Phillips formula. Since Marathon has persistently failed to comply with the applicable statutes, regulations, and terms of its leases, the government requests an order from this court cancelling the leases and requiring Marathon to account for all royalty payments due and for judgment in the proper amount.

On October 1, 1984, the federal government requested that a preliminary injunction issue in this case to compel Marathon to pay the royalties on production delivered to the LNG plant in accordance with the MMS orders. A conference was held on December 3, 1984 to expedite the case and a schedule was agreed to for the filing of motions addressing the merits. The federal government filed for summary judgment on December 17, 1984. The ruling on the government's application for a preliminary injunction was deferred until the motion for summary judgment was heard. I now grant summary judgment and direct that Marathon comply with the MMS orders.

THE CLAIMS

Marathon's amended complaint includes claims of contract impairment amounting to constitutional deprivation. Marathon argues that in the MMS letters of January 6, 1983 and February 28, 1983, the federal defendants gave clear indication of intention to breach and repudiate the terms of the settlement agreement and provisions within the federal leases. By so doing, Marathon claims, the federal defendants violated Marathon's constitutional rights, suggesting that only in federal court could Marathon obtain vindication of its constitutional rights. Alternatively, Marathon contended that the Administrative Procedure Act provided for immediate judicial review of the MMS orders.[14]

So far as Marathon's contract and constitutional claims are concerned, I conclude they are entirely without merit. Under the statutes and regulations providing for the administration of federal oil lease [sic], MMS has the authority and the responsibility to determine the reasonable value of gas production for the purpose of computing royalties. The settlement agreement of February 6, 1981 can in no way restrict the proper exercise of the agencies' statutory authority. Moreover, I conclude no constitutional impairment of contract or other constitutional deprivation is involved in this litigation.

Apart from Marathon's constitutional claims, I do conclude that Marathon is entitled to judicial review of the MMS orders pursuant to § 704 of the Administrative Procedure Act without awaiting further administrative proceedings. The federal defendants at an earlier stage of this proceeding had urged that judicial review was now inappropriate because Marathon had failed to exhaust administrative remedies. The federal defendants have since withdrawn the claim of lack of administrative finality and have agreed that judicial review of the administrative proceedings is now appropriate, and I so hold.

---

[14] 5 U.S.C. § 704 (1982).

SCOPE OF REVIEW

Since the federal defendants have moved for summary judgment in this case, the test is whether, with respect to any dispositive issue, there is any genuine issue as to any material fact.[15] If not, I must decide whether, construing the evidence in the light most favorable to the plaintiff Marathon, the defendants are entitled to judgment as a matter of law.

Section 706 of the Administrative Procedure Act (APA) establishes the appropriate standard of judicial review of agency decision. Under that provision, the agency's determination must be set aside if found to be arbitrary or capricious, or in violation of constitutional, statutory, or procedural requirements.[16]

Given my earlier rejection of Marathon's constitutional claims, I must now make a three-part determination.[17] First, did the agency act within the scope of its statutory authority? In making this inquiry, I need only determine whether the agency was in substantial compliance with the applicable statute(s).[18] Second, was the agency decision "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"?[19] As the Supreme Court has observed:

> To make this finding the court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear

---

[15] Fruehauf Corp. v. Royal Exchange Assurance of America, Inc., 704 F.2d 1168, 1171 (9th Cir. 1983).

[16] 5 U.S.C. § 706(2)(A)-(D). Subsections (2)(E) and (2)(F) of § 706 apply only under a limited set of circumstances not relevant here. *See* Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 414-15 (1971).

[17] *Overton Park*, 401 U.S. at 415-17; Arizona Past and Future Foundation, Inc. v. Lewis, 722 F.2d 1423, 1425 (9th Cir. 1983).

[18] MarkAir, Inc. v. Civil Aeronautics Board, 744 F.2d 1383, 1385 (9th Cir. 1984).

[19] 5 U.S.C. § 706(2)(A).

> error of judgment. Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency.[20]

Third, did the agency comply with all procedural requirements?[21]

In reviewing an agency decision, the agency's own interpretation of the applicable statutes is entitled to substantial deference.[22] Deference is even more clearly in order where an administrative regulation, rather than a statute is involved.[23] According to the Supreme Court, "the ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation."[24]

To uphold the MMS orders, I need not find that the MMS's interpretation of the statutes and regulations is the only reasonable interpretation, nor that it is the interpretation a court would reach if initially faced with the question. I need only find that it is a reasonable interpretation.[25] I must ascertain whether

---

20 *Overton Park,* 401 U.S. at 416 (citations omitted).

21 In this case, Marathon does not challenge the MMS orders on the basis of procedural error.

22 Chevron, U.S.A., Inc. v. NRDC, __ U.S. __, 104 S. Ct. 2778, 2782-83 (1984); Blum v. Bacon, 457 U.S. 132, 141-42 (1982); MarkAir, Inc. v. Civil Aeronautics Board, 744 F.2d 1383, 1385 (9th Cir. 1984); Olivares v. Immigration and Naturalization Service, 685 F.2d 1174, 1177 (9th Cir. 1982).

23 Udall v. Tallman, 380 U.S. 1, 16-17 (1965).

24 Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945); *see also* Hoover & Bracken Energies, Inc. v. United States Department of the Interior, 723 F.2d 1488, 1489 (10th Cir. 1983) (according considerable deference to Department of Interior's interpretation of what is now 30 C.F.R. § 206.103), *cert. denied,* __ U.S. __, 105 S. Ct. 93 (1984).

25 American Paper Institute, Inc. v. American Electric Power Service Corp., 461 U.S. 402, 422-23 (1983).

MMS "articulate[d] a rational connection between the facts found and the choice made."[26]

DISCUSSION

Although Marathon has articulated a wide variety of claims and arguments in this case, the focus of the dispute centers upon whether MMS has the authority to use the net back theory of valuation for computing royalties on the gas delivered to the Nikisi [sic] LNG plant.

The Mineral Lands Leasing Act,[27] enacted in 1920 and amended since, governs federal oil and gas leases. The Act was intended "to promote wise development of natural resources and to obtain for the public reasonable financial returns on assets belonging to the public."[28] The gas leases at issue in this case were granted under the authority of the Mineral Lands Leasing Act and by their terms are "subject to the terms and provisions of" the Act.[29]

Between 1976 and 1981, the General Accounting Office (GAO) issued several reports documenting problems in federal oil and gas royalty management and collection.[30] The October 1981 report identified the shortcomings:

> Historically, the Geological Survey has not placed a high priority on collecting oil and gas royalties.

---

[26] Bowman Transportation, Inc. v. Arkansas-Best Freight Systems, Inc., 419 U.S. 281, 285 (1974); Kunaknana v. Clark, 742 F.2d 1145, 1151 (9th Cir. 1984).

[27] 30 U.S.C. §§ 181-287 (1982).

[28] Mountain States Legal Foundation v. Andrus, 499 F. Supp. 383, 392 (D. Wyo. 1980).

[29] *See* leases reprinted in A.R. 14.

[30] *See* GAO, Oil and Gas Royalty Collections — Longstanding Problems Costing Millions (Oct. 29, 1981), A.R. 56; GAO, Oil and Gas Royalty Collections — Serious Financial Management Problems Need Congressional Attention (April 13, 1979), A.R. 57; GAO Indian Natural Resources — Part II: Coal, Oil and Gas, Better Management Can Improve Development and Increase Indian Income and Employment (Mar. 31, 1976), A.R. 58.

> Because sufficient management attention has not been focused on correcting deficiencies previously reported, financial management problems existing 20 years ago persist today. As a result, the Geological Survey is not collecting all oil and gas royalties; hundreds of millions of dollars owed the Government may be going uncollected each year. Moreover, millions of dollars in royalty income are not collected when due, thus increasing the Government's interest costs.[31]

In July 1981, the Secretary of the Interior established the Commission on Fiscal Accountability of the Nation's Energy Resources (known as the Linowes Commission) to investigate the problems. The Commission issued its lengthy report in January 1982, detailing 60 recommendations for revising the system.[32] The report summarized:

> Management of royalties for the Nation's energy resources has been a failure for more than 20 years. Because the Federal government has not adequately managed this multibillion dollar enterprise, the oil and gas industry is not paying all the royalties it rightly owes. The government's royalty record-keeping for Federal and Indian oil and gas leases is in disarray. For this reason, the exact amount of underpayment is unknown. The results of individual audits, which have often uncovered large underpayments, suggest that hundreds of millions of dollars due the U.S. Treasury, the States, and Indian tribes are going uncollected every year.
>
> * * * *
>
> The Nation can no longer afford mismanagement of royalties for its energy resources. The stakes are too high. With the rapid escalation of energy prices, oil and gas royalties have risen from less than $500 million in 1971 to more than $4 billion in 1981.
>
> The government's royalty management system needs a thorough overhaul.[33]

---

[31] A.R. 56 at 1.

[32] A.R. 55.

[33] *Id.* at xv.

Both the Secretary of the Interior and Congress responded to the Linowes Commission report. The Secretary reorganized the royalty management and collection functions of the Department under the newly-created Minerals Management Service, and revised the fiscal and production accounting system.

Congress, on December 21, 1982, enacted the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA).[34] The express purpose of FOGRMA included:

> (1) to clarify, reaffirm, expand, and define the responsibilities and obligations of lessees, operators, and other persons involved in transportation or sale of oil and gas from the Federal and Indian lands and the Outer Continental Shelf;
>
> (2) to clarify, reaffirm, expand, and define the authorities and responsibilities of the Secretary of the Interior to implement and maintain a royalty management system for oil and gas leases on Federal lands, Indian lands, and the Outer Continental Shelf;
>
> (3) to require the development of enforcement practices that ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States and Indian lessors and those inuring to the benefit of States;[35]

The legislative history of FOGRMA provides additional evidence that the law was intended to ensure that oil and gas royalties were accurately and promptly assessed and collected.[36] In FOGRMA, Congress mandated that the Secretary audit oil and gas lease accounts and make additional collections as warranted.[37] Furthermore, the statute states that "[t]he

---

[34] 30 U.S.C. §§ 1701-1757 (1982).

[35] *Id.* § 1701(b).

[36] *See* H.R. Rep. No. 859, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. Code Cong. & Ad. News 4268-4300; *see also* legislative history materials reprinted in A.R. 54.

[37] 30 U.S.C. § 1711(c)(1).

Secretary shall give priority to auditing those lease accounts identified by a State or Indian tribe as having significant potential for underpayment."[38]

Under the Minerals Lands Leasing Act, "[t]he Secretary of the Interior is authorized to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of [the Act]."[39] These regulations have the force and effect of statutes when not in conflict with such statutes.[40] The leases at issue in this case, in addition to being subject to the terms of the Mineral Lands Leasing Act, are also "subject . . . to all reasonable regulations of the Secretary of the Interior now or hereafter in force" unless inconsistent with the leases themselves.[41]

Administrative regulations governing MMS are found in 30 C.F.R. ch. II (1984). The particular regulation at issue in this case is 30 C.F.R. § 206.103, which provides:

> § 206.103 Value basis for computing royalties.
>
> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined

---

38 *Id.*

39 30 U.S.C. § 189.

40 California Co. v. Seaton, 187 F. Supp. 445, 449 (D. D.C. 1960), *aff'd sub nom.* California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961).

41 *See* leases reprinted in A.R. 14.

> by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Under this regulation, royalties are to be based on "the estimated reasonable value of the product as determined by the Associate Director [for Royalty Management]" with the proviso that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof."

The regulation enumerates several factors to be considered in determining reasonable value, but does not mandate that any particular formula be used to compute reasonable value. In fact, the Associate Director is expressly directed to consider, in addition to the enumerated factors, "other relevant matters." The thrust of the regulation is that the value for royalty computation purposes set by the Associate Director must be reasonable. The only specific requirement in the regulation is that this value be no less than "gross proceeds." Thus this regulation vests considerable discretion in the Associate Director to decide what the "reasonable value" for royalty purposes shall be.[42]

The federal gas leases at issue in this case are by their own terms "subject to the terms and provisions of [the Mineral Lands Leasing Act] and to all reasonable regulations of the Secretary of the Interior now or hereafter in force, when not inconsistent with any express and specific provisions herein."[43]

---

[42] *See* Continental Oil Co. v. United States, 184 F.2d 802, 821 (9th Cir. 1950).

[43] *See, e.g.*, Lease No. 028056 at 1, attached as Exhibit A to Marathon's Amended Complaint (filed Sept. 4, 1984).

The leases also provide that the lessee shall pay the lessor "12½ percent royalty on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations."[44] The leases further state:

> It is expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all oil, gas, natural gasoline, and other products obtained from gas, due consideration being given to the highest price paid for a part of for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters and, whenever appropriate, after notice and opportunity to be heard.[45]

Both the regulations and the leases, as discussed above, vest in the administrative agency the authority to establish the basis for computing royalties. The regulations require that the basis for royalty purposes "shall be the estimated reasonable value of the product as determined by the Associate Director." The leases expressly provide that "the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty."

As a preliminary matter, Marathon suggests that MMS by reason of prior agency action may well have been estopped from making the July 8 and October 5 orders. In support of this position, Marathon relies upon the February 6, 1981 settlement agreement and the September 10, 1979 "Duletsky Memo."

As to the settlement agreement,[46] it was by its terms effective "until such time as change in market conditions, State and Federal law, or regulations adopted thereunder . . . necessitate a revision in the method used to determine the well-

---

[44] *Id.* at 2.

[45] *Id.*

[46] Letter of Feb. 6, 1981 from James P. Murphy, Marathon Oil Co., to Barry A. Boudreau, USGS, A.R. 145.

head value."[47] By January 1983, MMS determined that such changes in market conditions had occurred. In December 1982, Marathon executed a new contract with Alaska Pipeline Company (APL to sell its gas from the Kenai Unit and other nearby units at a base price of $2.32/Mcf. This price is in contrast to the $2.0149/Mcf Phillips formula price, and the $.586/Mcf price under the 1975 APL contract.[48] The higher prices being paid for Kenai gas under the new sales contracts were an indication to MMS that the settlement agreement no longer reflected the true value of the gas delivered to the LNG plant. I conclude that the terms of the provision in the settlement agreement expressly provided for revision in the event of a change in market conditions. Therefore, the February 6, 1981 settlement agreement in no way precluded MMS from later proposing a revised method of valuation.

Turning to the "Duletsky Memo,"[49] I likewise conclude that this document did not bind the federal defendants to a fixed and unalterable position. This memorandum constituted the response of John Duletsky, Acting Chief, Conservation Division of USGS, to an internal inquiry about how to value Kenai gas for royalty purposes. Duletsky discussed the applicability of a net back method of valuation to satisfy the requirement that the value be not less than gross proceeds, and

---

[47] *Id.* at 3.

[48] *See* Federal Defendants' Memorandum of Points and Authorities in Support of Motion for Summary Judgment and Dismissal at 21-24 (filed Dec. 17, 1984) [hereinafter cited as Federal Defendants' Memorandum in Support]. Although Marathon refers to this discussion of contract prices as "*post hoc* rationalization," Marathon does not allege that the facts cited by MMS are incorrect. *See* Memorandum of Marathon in Opposition to Motion of Federal Defendants for Summary Judgment and Partial Dismissal at 54-55 (filed Jan. 2, 1985) [hereinafter cited as Memorandum of Marathon in Opposition].

[49] Memorandum of Sept. 10, 1979 from John Duletsky, Acting Chief, Conservation Division, USGS, to Oil and Gas Supervisor, Anchorage, Alaska, A.R. 124.

then concluded: "The term 'gross proceeds' . . . in our opinion, would be impractical to administer with respect to the Marathon [LNG] situation."[50]

I interpret Duletsky's position to be precisely as stated — that the use of the net back method was determined to be "impractical" when he authored the memorandum of September 10, 1979. Duletsky did not maintain that the gross proceeds regulation was not applicable to the LNG, nor could he rule out the possibility that the situation might change. In his memorandum Duletsky specifically noted that the agency "should also seek to establish a rational relationship between the landed value of the LNG in Japan and the value at the unit for royalty computation purposes so that the value for royalty purposes may be adjusted whenever there is an increase in the landed price."[51] In this statement, Duletsky acknowledged the relevance of the sales price in Japan to determination of value for royalty purposes. In fact, the settlement agreement of February 1981 established a basis for computing value for royalty purposes based on percentage of price paid in Japan for LNG.

I cannot agree with Marathon's contention that the Duletsky memorandum constituted an "express finding that the [gross proceeds] clause has no application to Marathon's LNG gas."[52] Given MMS's ongoing responsibility to ensure collection of all royalties due, I conclude the Duletsky memorandum represented nothing more than the position adopted at that time limited to the precise circumstances then existing.

---

[50] *Id.* at 2.

[51] *Id.* at 4.

[52] *See* Marathon's Supplemental Memorandum in Opposition to the Federal Defendants' Motion for Summary Judgment and Partial Dismissal at 14 (filed Jan. 16, 1985) [hereinafter cited as Marathon's Supplemental Memorandum in Opposition].

The doctrine of equitable estoppel is applied to the government only under unusual circumstances.[53] Courts are especially reluctant to estop the government in cases involving rights to public lands.[54] Estoppel will be applied only "if the government's wrongful conduct threatens to work a serious injustice and if the public's interest would not be unduly damaged."[55] In this case, Marathon has not alleged any "serious injustice" resulting from MMS's decision to use the net back method to comply with the gross proceeds requirement in the regulation. Furthermore, the public treasury would suffer if these royalties due from gas leases on federal lands were not collected as due. I conclude that neither the 1981 settlement agreement nor the 1979 Duletsky memorandum preclude the agency from making its July and October orders. The question then becomes whether the valuation method adopted by MMS satisfies statutory and regulatory requirements and whether it is consistent with the leases.

The regulation[56] requires that the value of production for royalty purposes be not less than "the gross proceeds accruing to the lessee from the sale thereof." The phrase "gross proceeds" is not defined in the regulations. Marathon claims that the gross proceeds provision operates only to require that the value for royalty purposes include any additional sums, such as tax reimbursements, received by the lessee from the purchaser of the gas.[57]

I do not agree that the phrase should be so narrowly interpreted. One treatise defines "proceeds" as "the money

---

53 Union Oil Co. v. Morton, 512 F.2d 743, 748 n.2 (9th Cir. 1975).

54 *Id.*

55 *Id.* (quoting United States v. Lazy FC Ranch, 481 F.2d 985, 989 (9th Cir. 1973)).

56 30 C.F.R. § 206.103 (1984).

57 Marathon's Supplemental Memorandum in Opposition, *supra* note 52, at 8-9.

obtained by an actual sale."[58] Marathon differentiates between "proceeds" type royalty clauses and "wellhead value" royalty clauses.[59] According to Marathon, the clause at issue here is a "wellhead value" royalty clause, and therefore the royalty value must be based on actual sales price in the field. I agree that the first sentence of the regulation directs the Associate Director to look to sales price in the field. However, the regulation does not end there. In the second sentence, it requires that the royalty basis be not less than the gross proceeds accruing to the lessee. Thus this regulation combines characteristics of a "wellhead value" royalty clause with characteristics of a "proceeds" type royalty clause. By its own language, the provision aims to ensure that the gross proceeds accruing to the lessee is the absolute minimum value for computation of royalties. In describing a "proceeds" type royalty clause, Professor Hemingway states: "Royalty payable upon the 'proceeds' of the sale of gas will be computed on the basis of aggregate gross receipts from all products less the costs of marketing and transportation."[60]

The gas Marathon delivers to the LNG plant is neither sold at the wellhead, nor at the LNG plant. Thus there is no simple way for MMS to value this production. The first arm's-length transaction involving this gas is the sale of the LNG in Japan. Recent changes in economic conditions suggested to MMS that neither the contract price for gas sold to Alaska Pipeline Co., nor the Phillips formula set out in the 1981 settlement agreement, represented a "reasonable value" for royalty computation purposes. MMS gave "due consideration" to the various factors and information before it in arriving at its

---

[58] 8 H. Williams & C. Meyers, *Oil & Gas Law: Manual of Oil & Gas Terms* 572 (1982).

[59] Memorandum of Marathon in Opposition, *supra* note 48, at 17-19.

[60] R. Hemingway, *The Law of Oil and Gas* § 7.4, at 351 (2d ed. 1983).

decision.[61] To capture the true value of the LNG being sold in Japan, MMS determined it was necessary to look at the landed price in Japan and work back to arrive at a reasonable wellhead value. To do this, MMS proposed to make allowances for costs of liquefaction and transportation, and for a reasonable rate of return on the LNG plant. Deducting these allowances from the sales price in Japan would thus yield an estimated wellhead value for the gas.

Is there "good reason" supporting MMS's decision to look to the sales price in Japan, rather than to open market contracts for the sale of other gas from the Kenai field? Again, I conclude yes. The regulation provides:

> In the absence of good reason to the contrary, value computed on the basis of the highest price per . . . thousand cubic feet . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality . . . gas . . . produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Marathon contends that this provision should be followed to arrive at a reasonable value of gas delivered to the LNG plant for royalty purposes.[62] I conclude, however, that there exists "good reason to the contrary" warranting use of another method.

---

[61] *See* Transcript of Deposition of Robert E. Boldt, Dec. 13, 1984 [hereinafter cited as Boldt Deposition].

[62] *See* Memorandum of Marathon in Opposition, *supra* note 48, at 22-24.

By its terms, the provision refers to "the price . . . paid or offered at the time of production in a fair and open market for the major portion of like quality . . . gas . . . produced and sold from the field or area." This assumes that reasonable value can be ascertained based on arm's-length transactions negotiated by unrelated parties each acting in their own self interest in competition with others.

It is obvious that market value of gas in any field will vary depending upon a wide variety of factors. So far as the Kenai field is concerned, 42% of the gas produced in 1982 was delivered to the ammonia and urea plant at Nikiski owned by Collier Chemical, a subsidiary of Union Oil. An additional 16% of production was delivered to the LNG plant owned by Marathon and Phillips. Alaska Pipeline Company bought 31% of production for distribution in the Anchorage market and 9% of production was rented to the Swanson River Field Unit for pressure maintenance. The gas delivered to the LNG plant presents a special, unique situation. At the plant the gas is cooled until it becomes liquid, then transported to Japan, and there sold. To capture the true value of this gas, it is reasonable for MMS to look to the proceeds accruing to Marathon in Japan.

The regulation requires that "Under no circumstances shall the value of production . . . for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale . . . or less than the value computed on such reasonable unit value as shall have been determined by the Secretary." Did MMS satisfy the explicit requirement that the value for royalty purposes be not less than the "gross proceeds" accruing to Marathon from the sale of the gas? I conclude the answer is yes. In fact, MMS determined that the net back method was necessary to satisfy the gross proceeds requirement. I agree with this determination.

Obviously the February 1981 settlement agreement demonstrates that the price paid for gas by Alaska Pipeline on its

long-term contract failed to provide reasonable value for purposes of computing royalty on that portion of the gas delivered to the LNG plant for sale in Japan. Even under the so called Phillips formula of 36% of the price received in Japan, the additional royalties from January 1, 1980 through February 1981 were computed to be $1,834,160.00. Thus Marathon's argument that "the 'gross proceeds' received by the lessee from the sale of [the LNG] with its enhanced values in a distant market are not indicative of the value of the raw material feedstock gas produced at the lease"[63] has a hollow ring. Since January 1, 1980, the effective date of the settlement agreement, Marathon paid royalties based on a "value" derived from the sales price in Japan. Marathon expressly agreed to this method in the February 1981 settlement agreement. Marathon cannot now credibly argue that landed sales price in Japan is irrelevant to the reasonable value for purposes of computing royalties.

Is MMS's net back method consistent with the regulatory language directing the agency to determine the *"value of production"* for royalty purposes? Marathon argues that this language requires that royalties be based on the value of production *at the lease.*[64] I agree with this basic premise. However, nothing in the regulation precludes MMS from looking at the sales price in Japan as a means to determine the reasonable value of production at the lease. MMS has done just this by taking the landed sales price, making allowances for liquefaction and transportation costs, and thereby deriving a reasonable value at the lease. The regulation does not preclude such computations, but rather requires them to ensure that the value chosen is not less than the gross proceeds accruing to the lessee. Thus I conclude that in deriving a value for royalty

---

[63] Marathon's Supplemental Memorandum in Opposition, *supra* note 52 at 9.

[64] *See id.* at 7-8.

purposes from the sales price in Japan, MMS complied with the regulatory requirement that royalties be based on the "value of production."

MMS is charged with managing these national resources and ensuring that full royalties are levied and collected. Deriving an estimated wellhead value from the sales price of the LNG in Japan is, I conclude, a reasonable method of establishing a basis for computing royalties.

Furthermore, contrary to Marathon's assertions, the MMS orders do not represent a "stark departure" from previous agency positions.[65] As early as October 1977, the government took the position that to satisfy the gross proceeds provision, value for royalty purposes should be derived from the sales price in Japan.[66]

Does the regulation permit MMS to look to the sales price of LNG, a liquified substance, in determining the value for royalty purposes of the natural gas at the lease? I conclude it does. Marathon contends that the LNG sold in Japan is a manufactured product quite distinct from the natural gas at the wellhead.[67] I am not persuaded. LNG is natural gas that has been cooled for purposes of storage or shipment.[68] There is no alteration of the chemical properties of the gas. Regardless of whether liquefaction is termed "processing" or "manufacturing," the fact remains that the LNG delivered in Japan is chemically identical to the natural gas at the lease. Therefore MMS did not violate the regulation when it directed that the royalty basis for the gas be derived from the sales price of the LNG in Japan.

---

[65] *See* Memorandum of Marathon in Opposition, *supra* note 48, at 7-8.

[66] *See* Letter of Oct. 31, 1977 from Rodney A. Smith, USGS, to John R. South, Marathon Oil Co., A.R. 100.

[67] *See* Memorandum of Marathon in Opposition, *supra* note 48, at 37-41.

[68] *See* 8 H. Williams & C. Meyers, *Oil & Gas Law: Manual of Oil & Gas Terms* 405 (1982).

For these reasons, I conclude that the MMS orders directing Marathon to use the net back method fall within the agency's authority under the statutes and regulations. I also conclude that the orders neither violated nor were inconsistent with provisions of the leases. The leases by their express terms provide for a royalty to be paid "on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations."[69] Marathon argues that like the regulatory language, this lease language requires royalties to be computed on value of production *at the lease.*[70] However, I have concluded that the net back method is a valid means of estimating the value of production for royalty purposes. Moreover, the leases themselves provide that the Secretary of the Interior has the authority to establish reasonable values for computation of royalties. I conclude that the MMS orders did not violate the terms of the leases.

In addition to challenging the substance of the MMS orders, Marathon also argues that the orders are invalid because MMS was unduly influenced by CIRI.[71] Marathon cites two Memoranda of Understanding (MOUs) between MMS and CIRI.[72] Marathon claims that by entering into the MOUs with CIRI, MMS violated a provision of ANCSA preserving existing rights of lessees of federal lands conveyed to

---

69 *See* Lease No. 028056 at 2, attached as Exhibit A to Marathon's Amended Complaint (filed Sept. 4, 1984).

70 Marathon's Supplemental Memorandum in Opposition, *supra* note 52, at 4-7.

71 *See* Memorandum of Marathon in Opposition, *supra* note 48, at 24-31; Marathon's Supplemental Memorandum in Response to Reply Memorandum of Cook Inlet Region, Inc. at 2-11 (filed Jan. 23, 1985).

72 Memorandum of Understanding Between Minerals Management Service & Cook Inlet Region, Inc. (Jan. 3, 1983), A.R. 17 [hereinafter cited as MOU I]; Memorandum of Understanding II Between Minerals Management Service and Cook Inlet Region, Inc. (Aug. 9, 1983), A.R. 18 [hereinafter cited as MOU II].

native corporations,[73] and unlawfully delegated administrative authority and discretionary decisionmaking to CIRI, a private party.

MOU I was executed by Robert E. Boldt, Associate Director of Royalty Management for MMS, on January 3, 1983.[74] In the agreement, MMS made a partial waiver of administration of the leases to CIRI to enable CIRI to negotiate directly with Marathon and Union Oil Co., the lessees, to try to settle royalty and other disputes, and, if necessary, to bring suit in its own name.[75] MOU I also provides that CIRI may request that MMS audit the leases, and that MMS shall consult with CIRI regarding any lease matters which might affect CIRI's interests.[76]

I conclude that in executing MOU I, MMS did not unlawfully delegate its authority or otherwise violate Marathon's rights or interests. Paragraph 2 of the agreement lists areas of dispute between CIRI and the two lessees, Marathon and Union, primarily concerning royalties. The agreement itself states that "[this] partial waiver of administration is with regard to CIRI's negotiation of CIRI's interest in the Leases . . . with respect to the unresolved issues listed in paragraph 2(a)

---

[73] ANCSA § 14(g), 43 U.S.C. § 1613(g) (1982).

[74] *See* MOU I, A.R. 17.

[75] *Id.* ¶¶ 2, 3.

[76] *Id.* ¶¶ 4, 6, 7. In addition, paragraph 5 of the agreement stated that the determinations in USGS letters dated October 1, 1979 and November 6, 1979 were withdrawn and rescinded insofar as they affected CIRI's interests. The administrative record contains several letters from USGS to Union Oil Company bearing these dates, *see* A.R. 126, 128, 129, but only one letter to Marathon. *See* Letter of Nov. 6, 1979 from Rodney A. Smith, USGS, to Marathon Oil Co., A.R. 127. As the federal defendants and CIRI point out, this November 6 letter was expressly rescinded by USGS one month later. *See* Letter of Dec. 11, 1979 from Rodney A. Smith, USGS, to Marathon Oil Co., A.R. 130. Marathon has not refuted this, and therefore has not explained how paragraph 5 of MOU I could have adversely affected its interests.

through (e). By this partial waiver CIRI is empowered to enter into negotiations and effect a settlement of those issues. . . ." ANCSA § 14(g) expressly authorizes the responsible agency to waive administration of leases on land conveyed pursuant to ANCSA, such as the land on which these leases are located.[77] The plain language of MOU I indicates that the purpose of the waiver was to enable CIRI to negotiate an out of court settlement of the royalty issues. MMS did not unlawfully transfer any decisionmaking authority to CIRI.

The provisions in MOU I providing that CIRI may request an audit, and that MMS shall consult with CIRI, likewise do not violate Marathon's rights. ANCSA provides that the native land settlement process should be accomplished "with maximum participation by Natives in decisions affecting their rights and property."[78] Thus MMS is not only entitled but in fact expressly directed to communicate with CIRI concerning the leases. Furthermore, any private party has the right to make its opinions known to the government and to advocate positions which would be to its benefit.

But there is additional evidence to support my conclusion that MOU I did not improperly influence MMS's decisionmaking process. In his sworn deposition testimony, Robert E. Boldt, MMS's Associate Director for Royalty Managment, state in response to several direct questions that MOU I did not influence or affect MMS's decision to issue the royalty orders at issue here.[79]

In MOU II, executed on August 9, 1983,[80] MMS adopted several "administrative standards" governing the leases.[81]

---

77 43 U.S.C. § 1613(g) (1982).
78 *Id.* § 1601(b).
79 Boldt Deposition, *supra* note 61, at 42, 46, 69, 96, 98, 110.
80 A.R. 18.
81 *Id.* ¶¶ 3, 4.

Marathon argues that by adopting these standards, MMS unlawfully contractually committed itself to certain positions, thereby abdicating its responsibility for independent decisionmaking. However, the initial MMS order directing Marathon to use the net back method to compute royalties was issued on July 8, 1983, one month before MOU II was signed.[82] Thus MOU II could hardly have influenced MMS's decision to issue the July 8 royalty order. Furthermore, the July 8 order established the values to be used in the computation of royalties using the net back method. The decision to use that method had been made and so communicated to Marathon months earlier in the January 6, 1983 letter. The two subsequent MMS orders at issue in this case, dated October 5, 1983 and June 11, 1984, merely directed Marathon to comply with previous orders.[83] These subsequent orders were thus similarly not the result of any improper influence caused by MOU II.

I thus conclude that the MOUs between MMS and CIRI did not unlawfully influence the issuance of the MMS royalty orders. MMS neither contracted to take action beyond that already mandated by law, nor agreed to refrain from exercising its independent decisionmaking authority. The MMS net back royalty orders to Marathon are not invalidated by the MOUs.

Marathon raises several other complaints about the procedure by which MMS issued its orders. Marathon objects to the Administrative Record compiled and submitted by the federal defendants.[84] According to Marathon, there are documents in

---

[82] *See* Letter of July 8, 1983 from William H. Feldmiller, MMS, to Curtis Dowden, Marathon Oil Co., A.R. 8.

[83] *See* Letter of October 5, 1983 from Milton K. Dial, MMS, to D.J. Durham, Union Oil Co. (as agent for Marathon Oil Co.), A.R. 9; Letter of June 11, 1984 from Assistant Secretary for Land and Minerals Management, Department of the Interior, to William E. Swales, Marathon Oil Co. and Ray A. Burke, Union Oil of California, A.R. 11.

[84] *See* Memorandum of Marathon in Opposition, *supra* note 48, at 32-37.

the record which should not be there, and certain documents are excluded with should be included. In particular, Marathon claims that "[m]uch of the so-called 'record' contains *post hoc* rationalizations,"[85] and points to documents created after the MMS royalty order(s) had been issued.

In a case such as this, the court is reviewing the agency's determination. There is no statutory requirement for formal rulemaking or adjudicatory proceedings. Therefore there is no formal agency record created to support the decision. Despite the absence of a formal record, it is the duty of the court to review the decision "based on the full administrative record that was before the [decisionmaker] at the time he made his decision."[86]

The federal defendants have compiled an admittedly voluminous administrative record in this case. As explained in their memorandum, "[t]he Department . . . accumulated all documents which it considered to have even the slightest relevance to the determination, seeking to avoid any controversy with regard to the record."[87] The response from Marathon was that the record was *too* voluminous.

I cannot agree with Marathon. I do not find deficiencies in the administrative record that would require an evidentiary hearing on the issue of the composition of the record. The omission Marathon complains of is that the appeal documents it filed with the agency were not included in the record. The federal defendants have since supplemented the record to include those documents.[88] As to Marathon's claim that docu-

---

[85] *Id.* at 35.

[86] Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 420 (1971).

[87] Federal Defendants' Reply to Plaintiff's Opposition to Motion for Summary Judgment at 11 (filed Jan. 11, 1985) [hereinafter cited as Federal Defendants' Reply Memorandum].

[88] *See* Notice of Lodging Supplement to Administrative Record (filed Jan. 22, 1985).

ments were included which were created after the initial royalty order was issued, I find no prejudice to Marathon. According to the federal defendants, these documents were included because they support the subsequent orders and the Notice of Noncompliance issued to Marathon.[89] Such additions do not invalidate agency action unless substantial prejudice is shown to result.[90] Beyond the complaint that the record is too large, Marathon has not alleged that it suffered any substantial prejudice from the inclusion of these documents. Additional explanatory information is permitted to supplement the record.[91]

Marathon also claims that the MMS orders may have been improperly influenced by communications from congressional representatives.[92] However, Mr. Boldt, in his deposition, stated that any such communications occurred in April or May of 1984, almost a year after MMS issued its first royalty order.[93] Thus congressional communications could not have affected MMS's decision to issue the disputed royalty order.

In another claim, Marathon contends that by using different methods for valuing Marathon's gas delivered to the LNG plant and Union Oil Company's gas delivered to its ammonia/urea plant, MMS has violated Marathon's equal protection rights.[94] I do not agree. As discussed earlier, LNG is natural gas that has been cooled for shipment and storage

---

89 *See* Federal Defendants' Reply Memorandum, *supra* note 87, at 12.

90 United States v. Pierce Auto Freight Lines, Inc., 327 U.S. 515, 530 (1946).

91 Kunaknana v. Clark, 742 F.2d 1145, 1149 (9th Cir. 1984); Asarco, Inc. v. United States Environmental Protection Agency, 616 F.2d 1153, 1158-60 (9th Cir. 1980).

92 *See* Memorandum of Marathon in Opposition, *supra* note 48, at 45.

93 *See* Boldt Deposition, *supra* note 61, at 116.

94 *See* Memorandum of Marathon in Opposition, *supra* note 48, at 48-51.

purposes. It is chemically identical to the gas produced at the well. At least in this connection, it differs from ammonia or urea which are quite different products from LNG. But in each case, MMS is required to follow the regulation and determine the reasonable value for royalty purposes, with gross proceeds as the required minimum. There is no requirement that the gas delivered to the LNG plant be valued by the same method as the gas delivered to the ammonia/urea plant so long as the agency complies with the regulation.

Marathon claims that MMS irrevocably waived administration of one of CIRI's leases in the Kenai unit, Lease A-028142.[95] In support, Marathon cites an August 1982 letter from MMS to Union Oil Co.[96] In this letter, MMS notified Union that the lands covered by part or all of three leases had been conveyed to CIRI pursuant to ANCSA. As to the two leases which had been only partially conveyed, MMS explicitly stated that administration would remain with MMS and that lease records were to be retained by MMS.[97]

As to the third lease, the letter stated:

> Lease A-028142 has been transferred in its entirety to the Cook Inlet Region Inc. . . . [ANCSA § 14(g) provides that the United States may waive administration of a lease containing lands which have been conveyed in their entirety.
>
> Pursuant to the above, your case file will be transfered . . . to: Cook Inlet Region, Inc. . . . Further correspondence concerning these leases should be made to [CIRI].[98]

---

[95] Marathon's Supplemental Memorandum in Opposition, *supra* note 52, at 21-22.

[96] Letter of Aug. 25, 1982 from Jimmy W. Mayberry, MMS, to Wayne Hunt, Union Oil Co. of California, included in A.R. 15.

[97] *Id.* at 2.

[98] *Id.* at 3.

Although in the letter MMS stated that the United States "may" waive administration as to this lease, there is no language indicating that the United States has in fact waived administration. The applicable regulation provides that the agency may retain administration of a lease conveyed in its entirety if the agency finds it to be in the interest of the United States.[99] Marathon contends that no such finding has been made, but offers no evidence in support of this contention. The regulation does not require that such a finding be made in a formal written document. In oral argument, counsel for the federal defendants suggested that MMS has continued to administer this lease.[100]

The August 1982 letter provided that the lease had been transferred in its entirety, and that the case file would be transferred to CIRI. MMS did not state, however, that it was waiving administration. Because the terms used are prospective, I conclude that MMS has not waived administration as to this lease. Therefore, the MMS royalty orders are effective as to this lease.

CONCLUSION

For the reasons stated I upheld the orders issued by MMS to Marathon requiring computation of royalties using the net back method. Based on this holding, I GRANT the federal defendants' Motion for Summary Judgment and Partial Dismissal. Marathon's claims against the federal defendants are accordingly DISMISSED. I further find that the federal defendants are entitled to an injunction. Marathon is accordingly ORDERED to comply with the terms of the three MMS royalty orders. I DENY Marathon's Motion for a Preliminary Injunction and Judicial Stay of Administrative Action. I

---

[99] 43 C.F.R. § 2650.4-3 (1983).

[100] Reporter's Transcript of Oral Argument on Motions at 83 (Jan. 4, 1985).

GRANT the federal defendants' prayer for an accounting to determine royalties due from Marathon. I retain jurisdiction to enter judgment for the United States when the amount has been ascertained, and to determine any remaining matters.

The federal defendants shall, within five days, serve and file a proposed Order consistent with this Opinion. Because I order Marathon to comply with the royalty orders, this decision is appealable as an injunction under 28 U.S.C. § 1292(a). Enforcement of this injunction is stayed for a period of ten days from the date the Order is signed and filed to enable Marathon to apply to the Court of Appeals for a stay pending appeal.

C. AGENCY ORDERS, INSTRUCTIONS AND NOTICE

1. Interior Department Assistant Secretary's Order Issued June 11, 1984.

[SEAL]

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

June 11, 1984

Mr. William E. Swales
Senior Vice President
Marathon Oil Company
539 Main Street
Findlay, Ohio 45840

Mr. Ray A. Burke
Senior Vice President, Energy Resources
Union Oil of California
461 S. Boylston Street
Los Angeles, California 90017

Gentlemen:

As you know, the Department of the Interior (Department) presently is involved in litigation with Marathon regarding the value used to compute royalties on gas produced and sold from certain Federal leases located in the Kenai Gas Field, Alaska (*Marathon Oil Company v. U.S.*, Civ. No. A83-208 Civ. (D. Alaska)). Related to this litigation are two orders issued by the Minerals Management Service (MMS) regarding royalties payable on these leases.

The first order was a letter dated July 8, 1983, from William Feldmiller, MMS, to Curtis Dowden, Marathon (Enclosure 1), which directed Marathon to begin calculating

royalties based on a net-back formula commencing with the royalty period August 1, 1983. According to our records, Marathon has not complied with this directive and has paid royalties since August 1 based upon a value considerably below that ordered by MMS.

The second order, dated October 5, 1983, from Milton K. Dial, Chief, Royalty Compliance Division, MMS, to Union Oil of California, paying agent for Marathon (Enclosure 2), directed Union to pay $717,705 in underpaid royalties for the period April 1983 to July 1983. According to our records, Union has not paid these royalties.

The obligation to pay royalties determined by MMS to be due and owing is not suspended by an administrative or judicial appeal of these orders. As a result, the Department is issuing this second order to Marathon, and to Union on behalf of Marathon, to pay the royalties due for the period April—July 1983 as prescribed in the letter of October 5, 1983, and to pay royalties in accordance with the July 8, 1983, letter for periods after July 31, 1983. This order is issued at the direction of the Secretary and, accordingly, constitutes a final decision by the Department pursuant to 43 C.F.R. Section 4.5(a).

If Marathon does not comply with both orders within 30 days from receipt of this letter, Marathon hereby is given notice that the Department will request the Attorney General of the United States to initiate proceedings in the United States District Court for the District of Alaska to cancel Marathon's interest in the Kenai leases. Lease cancellation for nonpayment of royalties is authorized by Marathon's leases (Section 7), Section 31 of the Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. Section 188, and by the applicable Departmental regulations (*see* 43 C.F.R. Section 1308.3(c)). In addition to initiating lease cancellation proceedings, the Department has available other enforcement measures.

It is still our hope that this situation can be resolved amicably between Marathon and the Government. We are available for further discussions if you desire.

Sincerely,

/s/ GARREY E. CARRUTHERS

Assistant Secretary for Land and Minerals Management

Enclosures

[Enclosures to this Order are omitted.]

2. Minerals Management Service Order Issued October 5, 1983.

[SEAL]

United States Department of the Interior

OFFICE OF THE SECRETARY
MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 5760
Denver, Colorado 80217-5760

MMS-RCD
MS 655

October 5, 1983

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. D.J. Durham
Union Oil Company of California
P.O. Box 7600
Los Angeles, California 90051

Dear Mr. Durham:

This office has conducted a review of the royalties paid by Union Oil Company (Union) on behalf of Marathon Oil Company (Marathon) for sales of natural gas produced from the Kenai Unit and delivered to the Liquified [sic] Natural Gas (LNG) plant at Nikiski, Alaska.

Under the terms of the applicable leases, the Department of the Interior is authorized to establish reasonable minimum values for purposes of computing royalty. Additionally, 30 C.F.R. 221.47 provides that "Under no circumstances shall the value of production . . . be deemed to be less than the gross

proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. . . ."

By Order dated January 4, 1980, the Secretary established a "value of no less than that paid to the State of Alaska for gas produced from the North Cook Inlet Field". Subsequently, by letter dated September 12, 1980, the minimum value was established based upon the so-called "Phillips Formula" (delivered LNG Contract price x 36 - $.0555 adjusted for quality as provided by NTL #5). By agreement dated February 17, 1981, Marathon agreed to abide by the terms of the "Phillips Formula" and to compute and pay royalties on that basis. On July 8, 1983, the Minerals Management Service (MMS), after concluding that the royalty paid pursuant to the "Phillips Formula" no longer met the regulatory criteria of 30 C.F.R. 221.47 due to changed market conditions, directed Marathon to calculate and pay royalty based upon a revised version of the "Phillips Formula" beginning with the payment due in August 1983. Marathon has refused to comply with the July 8, 1983, directive, and is pursuing an administrative appeal of the July 8, 1983, order.

As a result of a recent review, we have concluded that Union, as agent for Marathon, has paid royalty due the United States in periods prior to April 1983 using the "Phillips Formula." However, beginning April 1983 through July 1983, the last month of our review, Union, as agent for Marathon, has paid royalty using a value less than the minimum value directed by MMS or its predecessor agencies. Beginning in April 1983, Union, as agent for Marathon, has improperly, and contrary to MMS directives, used the value in the gas sales agreement with Alaska Gas Pipeline Company as the basis for royalty payments for the Kenai Unit. We have determined that, as a consequence, royalties for the months of April, May, June, and July have been underpaid by approximately $717,705. This amount was computed using the March 1983 unit price as

$1.817623, adjusted for Btu, times the reported production subject to royalty, less the amount previously paid by Union (see Attachments 1, 2, and 3).

Union, as agent for Marathon, is hereby directed to, within 30 days of receipt of this Order, recalculate the royalty due, consistent with the provisions of the "Phillips Formula" using the actual unit price for April, May, June, and July 1983, and submit payment of additional royalties so calculated. Furthermore, Union, as agent for Marathon, is hereby directed, until further notice to the contrary, to calculate and pay royalty due for periods after July 1983 consistent with the "Phillips Formula."

Attached is a "Bill for Collection" in the amount of $717,705 from the MMS Accounting Center in Lakewood, Colorado; your payment of this amount, or such amount as calculated to actual unit prices, should be sent to the address indicated on the Bill. A copy of all checks and Forms MMS-2014 (Report of Sales and Royalty Remittance) should be submitted to this office. Late payment penalties will be assessed at a later date consistent with applicable regulatory criteria.

Failure to respond to this assessment action within the allotted time period will result in alternative actions to secure your compliance. You have the right to appeal in accordance with the provisions of Title 30, Code of Federal Regulations, Part 290. Any appeal taken will be to the Director, MMS, and the notice of appeal must be filed with:

Mr. Milton K. Dial, Chief
Royalty Compliance Division
Minerals Management Service
Mail Stop 655
P.O. Box 25165
Lakewood, Colorado 80225
Telephone: (303) 231-3011

A copy of any appeal filed should be forwarded to:

Mr. Norman Bess
Chief Appeals Division
Minerals Management Service
Mail Stop 623
12203 Sunrise Valley Drive
Reston, Virginia 22091
Telephone: (703) 860-7251

within 30 days from the date of this letter. The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 C.F.R. 290.4, to present oral argument or evidence to the Director, MMS, and such motion should be filed with the Director who may, in his discretion, schedule a hearing at a time and place of his choosing. With the exception of the time fixed for filing a notice of appeal, the time for filing any documents in connection with an appeal may be extended by the Director, MMS. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

If you have any questions concerning this matter, please call Mr. Erasmo Gonzales, Regional Manager, Houston Regional Compliance Office, at (713) 229-7783.

Sincerely,

/s/ MILTON K. DIAL

Milton K. Dial,
Chief Royalty Compliance Division

Enclosures

[Attachments to this Order are omitted]

3. Minerals Management Service Order Issued July 8, 1983.

[SEAL]

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 25165
Denver, Colorado 80225

MMS-RVS

July 8, 1983

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Curtis Dowden
Anchorage Division, Production
Marathon Oil Company
Post Office Box 2380
Anchorage, Alaska 99510

Dear Mr. Dowden:

By a letter dated January 6, 1983, Marathon Oil Company (Marathon) was notified of the Minerals Management Service's (MMS) intent to determine the reasonable value for computing royalties on gas produced and sold from certain Federal leases located in the Kenai Gas Field. In that letter a "Proposed Methodology for Determining the Value for Royalty Purposes, of Natural Gas Produced on Federal and Indian leases in the Kenai Gas Field" was outlined and explained. The January 6, 1983, letter reaffirmed the soundness of the principles found in the net-back formula, but indicated that adjustments to the formula were necessary to reflect changes in economic conditions.

A subsequent letter dated February 28, 1983, which was sent at Marathon's request, provided additional detail on the proposed changes and worksheets instructing Marathon on the adjustments to be made to the manufacturing and transportation allowances. MMS directed Marathon to begin using actual processing and transportation costs to determine the then fixed coefficients found in the net-back formula. MMS concluded that such a change was warranted because of market changes within the Kenai area. A public hearing on the proposed change in the valuation formula was held on March 1, 1983, and written comments have been received. MMS has carefully reviewed the materials and comments submitted.

Having considered all the relevant materials bearing on the question of royalty computation for Kenai gas, including the price received by Marathon under its sales contract with Alaska Gas Pipeline Company for unprocessed gas, MMS concludes that the current net-back formula must be adjusted in the manner described and outlined in the January 6, 1983, and February 29, 1983 [sic], letters sent to Marathon. Therefore, Marathon is hereby directed to begin calculating royalties based on this adjusted formula for royalty valuation commencing with the royalty period August 1, 1983.

Marathon has the right to appeal this decision in accordance with the provision of Title 30, Code of Federal Regulations Part 290. Any appeal taken will be to the Director, Minerals Management Service, and notice of appeal must be filed with:

Mr. Norman Hess
Appeals Division
Minerals Management Service
Mail Stop 623
12203 Sunrise Valley Drive
Reston, Virginia 22091

within 30 days from the date of receipt of this letter.

The notice of appeal must be accompanied by a written showing, as Marathon may deem adequate, to justify reversal or modification of this decision. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. Marathon may also request approval, pursuant to 30 C.F.R. 290.4, to present oral argument or evidence to the Director, Minerals Management Service, and such motion should be filed with the Director who may, in his discretion, schedule a hearing at a time and place of choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any documents in connection with an appeal may be extended by the Director, Minerals Management Service. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

Please be aware that regulations provide, and it is MMS policy, that the filing of an appeal will not suspend the requirement for compliance with this decision, 30 C.F.R. § 221.66 (1982).

Sincerely yours,

/s/ WILLIAM H. FELDMILLER

William H. Feldmiller
Chief, Royalty Valuation and Standards Division

4. Minerals Management Service Instructions Issued February 28, 1983.

[SEAL]

United States Department of the Interior

OFFICE OF THE SECRETARY
MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 5810
Denver, Colorado 80217-5810

MMS-PVB

February 28, 1983

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Al Mechler, Jr., Manager
Anchorage Division Production
Marathon Oil Company
P.O. Box 2380
Anchorage, Alaska 99510

Dear Mr. Mechler:

Enclosed is the procedure to be used in valuing, for royalty purposes, the gas produced from the Alaska Kenai gas field. The gas produced by Marathon is liquefied and transported to Japan for sale.

The final unit value for royalty purposes will be expressed in the same manner as the method currently in use, the so-called "Phillips" formula ($V = AP - B$),

where: V is the value of the gas, for royalty purposes, on a per Mcf basis;

A is the proportion of the value per Mcf remaining after allowances are deducted for liquefaction of the gas and tankering it to Japan;

P is the delivered LNG contract price per Mcf in Japan or gross proceeds which accrue to Marathon, whichever is higher; and

B is the allowable transportation deduction per Mcf for the Kenai-Nikiski pipeline.

In determining an annual unit manufacturing and transportation allowance, Marathon is to apply the attached discounted cash flow procedure for recovering capital and amortized expenses associated with capital. Investment tax credit, depreciation, salvage and operating costs are taken into consideration. A reasonable return (profit), based on capital and amortized expenses will be allowed. Annual operating costs will be actual expenditures.

The enclosed worksheet will be updated annually and submitted to the Minerals Management Service (MMS). All backup materials shall be retained by Marathon to be made available for audit upon MMS request.

Marathon will compute the value, for royalty purposes, of the Kenai gas field gas as set forth in the enclosure and apply it prospectively for the upcoming 12-month period commencing with the July 1, 1983, royalty payment.

Copies of the worksheet are to reach MMS on or before the 1st day of July of each year. Marathon will pay royalties prospectively based on the revised worksheet calculation beginning the 1st day of July of each year.

Payments received will be considered accurate and correct, subject to possible audit within the six-year statute of limitations as established by the recent "Federal Oil and Gas Royalty Management Act of 1982."

We will be pleased to meet with you to discuss any questions you may have regarding this procedure.

/s/ WILLIAM H. FELDMILLER

William H. Feldmiller
Chief, Royalty Valuation and Standards Division

Enclosure

ENCLOSURE:

NET-BACK PROCEDURE TO BE USED IN VALUING, FOR ROYALTY PURPOSES, MARATHON'S ALASKA KENAI GAS FIELD PRODUCTION

General

Marathon's Kenai gas production is moved via pipeline to a processing plant, processed, and transported to the place of first sale in Japan. Storage facilities are required at the LNG plant. The value of the products at the point of sale is established by contract, but under no circumstances can the Minerals Management Service (MMS) accept less than gross proceeds as the basis for royalty valuation purposes.

By taking the contract value or gross proceeds and subtracting from it all costs and expenses incurred in processing, storing, and transporting the products between the point of sale and the lease, the value of the products at the lease boundary can be obtained. This procedure to arrive at a product value at the lease site is sometimes referred to as a net-back procedure.

Federal royalties are based upon the value of the gas at the lease boundary. In determining the value of Kenai gas at the lease, the value at the point of sale of the LNG sold over a year's period will be reduced by an amount equal to the allowable operating costs for that year for transportation and manufacturing plus an amortization payment. The purpose of the amortization payment is to recover, together with a return on investment, the depreciable capital expenditures and development costs or other expensed costs not immediately offset by revenues. This adjusted sales value will be divided by gas volumes processed and transported accordingly; thus resulting in a sales value at the lease on a per unit (Mcf) basis.

Amortization payments for an expenditure begins the year after the expenditure is made (or later if the expenditure item is

not put into service the following year). Sales must have taken place in order to offset amortization payments and operating costs.

Capitalized items and any associated expenses are amortized over a period of time equal to the depreciation life of the equipment as reported to the IRS. Development costs and expenses associated with capital investment shall be amortized over a period of time equal to the IRS guideline class life of major capitalized petroleum plants or the class life of the equipment with which the expenses are associated.

For any given year, expenditures can occur that require different amortization lives (five years, ten years, fifteen years, etc.). The payments for these expenditures shall be according to an established amortization schedule. Expenditures made in the same year and with the same amortization life shall be grouped together for purposes of making the amortization calculation. Each year new expenditures might be made and new amortization payments added while old amortization schedules expire and their payments drop. The total amortization payment for a computation year is the sum of all active amortization payments.

Allowable Capital Investment Costs

Allowable investment costs are generally those expenditures for fixed assets (including delivery and installation costs) that are directly associated with the liquefaction and transportation of the Kenai field gas. Allowable capital investment costs shall include those expenditures for fixed assets that are directly associated with transporting the natural gas from the gas field to the liquefaction plant, manufacturing the LNG, and transporting the LNG from the liquefaction plant to the point of sale.

The items listed below are generally considered as allowable capital investment costs:

Plant and office buildings; warehouses; shops; laboratories; sidewalks; fences; plant roads and rights-of-way for plant roads; fresh water wells and supply systems; pipeline systems; LNG tankering systems; general plant facilities such as heat and steam, power, fuel, and sewage; all related controls, meters (including plant inlet and sales meters), pipe valves, and fittings; and equipment items used in the liquefaction of the natural gas, such as absorbers, heat exchangers, coolers, chillers, and compression facilities for refrigeration or recompression of gas required during manufacturing.

Allowable Operation and Maintenance Expenditures

Operation and maintenance costs, which are those nondepreciable expenditures associated with the costs of operating and maintaining the plant and transportation facilities, may include the following items:

(1) Salaries and wages paid to employees and supervisors while engaged in operating and maintaining the plant and transportation facilities.

(2) Electrical or other energy expenditures, including any gas used in liquefaction and transportation.

(3) Chemicals and lubricants used for the purpose of liquefaction, protection, or cleaning the processing and transportation facilities.

(4) Repairs, contract labor, material, and supplies directly connected to the pipeline, plant, and LNG transportation system.

(5) Insurance and taxes (Federal and State income taxes are not an allowable deduction).

(6) Rental expenditures for leasing of equipment and/or plant site.

(7) General and administrative overhead costs (telephone service, payroll taxes, employee fringe benefits,

vehicle expenses, office supplies, etc.). The total of these costs shall be limited to expenditures directly attributable and allocable to the operation and maintenance of the pipeline, plant, and LNG transportation system.

Operation and maintenance expenditures will generally be limited to those items which are reasonable and represent an integral part of the liquefaction process. Such expenditures shall be supported by copies of the invoices retained at the office which makes royalty payments to MMS. These invoices and data shall be available for audit purposes when requested by MMS.

Return on Investment

The lessee shall present to MMS a proposed reasonable rate of return for this type of operation in the Alaska region at the time covered by this project. This proposal shall identify all components such as risk, cost of capital, etc., that are incorporated in this rate. If the lessee is unable to provide convincing evidence that their proposed rate of return is reasonable, MMS will fix a value and advise Marathon of the rate of return to be used.

Non-allowable Items

Non-allowable items include the following:

(1) Gas gathering system on the leases.

(2) Compressor fuel and associated expenditures to move the gas to the Nikiski LNG plant.

(3) Raw liquid sweetening facilities.

(4) All royalty payments.

(5) Federal and State income taxes.

[Amortization Worksheet
Provided by the Agency is Omitted Here]

5. Minerals Management Service Notice Issued January 6, 1983.

[SEAL]

MINERALS MANAGEMENT SERVICE
Reston, Virginia 22081

In Reply Refer To:
MMS-Mail Stop 660

January 6, 1983

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Al Mechler, Jr., Manager
Anchorage Division Production
Marathon Oil Company
P.O. Box 2380
Anchorage, Alaska 99510

Dear Mr. Mechler:

The Minerals Management Service hereby gives notice to the Marathon Oil Company of its intent to determine the reasonable value for computing royalties on gas produced and sold from certain Federal leases located in the Kenai Gas Field, located in Alaska, starting with the volumes produced in May of 1983. The leases in question produce gas that is shipped by pipeline to a Liquefied Natural Gas plant at Nikiski, Alaska, on the east side of the Cook Inlet. At the plant the gas is liquefied and loaded on ocean tankers for shipment to Japan for sale to Tokyo Electric Power Company and Tokyo Gas Company. Marathon has a 30 percent ownership interest in the liquified natural gas sold to these Japanese companies.

In the past, valuation of this gas in royalty calculations was based on a formula that performed a calculation to back out gas processing and transportation costs to determine the net value at the point of first sale. The basic net back valuation

theory of this formula is sound, but adjustments to the formula are necessary to reflect changing costs and prices due to economic conditions. The valuation methodology we propose for prospective royalty calculations is summarized in the attachment to this letter.

A public oral hearing on this matter with Minerals Management Service representatives will be held at 9:00 a.m. on February 15, 1983, at the MMS office in Anchorage, Alaska. The address of this office is:

Minerals Management Service
800 A Street, Suite 201
Anchorage, Alaska 99501

The Marathon Oil Company has 30 days from the date of this letter to file written comments, evidence, and legal arguments on this matter with the Minerals Management Service. Please send your comments to:

Mr. Robert E. Boldt
Associate Director for Royalty Management
Minerals Management Service
MS 660 USGS National Center
12201 Sunrise Valley Drive
Reston, Virgina 22092

At the hearing on February 15, 1983, you will have an opportunity to present your views orally to representatives of the Minerals Management Service. This action is pursuant to the regulatory authority in Title 30 of the Code of Federal Regulation, part 221.47.

Sincerely,

/s/ ROBERT E. BOLDT

Robert E. Boldt
Associate Director
Royalty Management Program

Enclosure

ENCLOSURE:

PROPOSED METHODOLOGY FOR DETERMINING THE VALUE FOR ROYALTY PURPOSES OF NATURAL GAS PRODUCED ON FEDERAL AND INDIAN LEASES IN THE KENAI GAS FIELD

The "Phillips Formula" currently used to value gas which is produced by Marathon from the Kenai Field, liquified [sic], and tankered to Japan, provides the unit value of the natural gas for royalty purposes. MMS will continue to value production using the "Phillips Formula." However, beginning in May 1983, and annually thereafter, the coefficients of the formula shall be updated to reflect current costs. The procedure for updating the coefficients involves determining the ratios of annual costs to total annual sales value and total annual sales volume respectively for the following categories:

(1) Liquifying [sic], storing, and tankering the natural gas, and

(2) Transporting the gas via pipeline from the lease to the inlet of the LNG plant.

The cost categories will consist of allowable yearly operating costs and yearly capital recovery costs, including a return* on capital and development expenditures. Capitalized ex-

---

* The after tax reasonable rate of return to be used will be established by MMS. Marathon shall present to MMS a proposed reasonable rate of return for this type of operation in the Alaska region at the time covered by this project. This proposal shall identify all components such as risk, cost of capital, etc., incorporated in this rate. If Marathon is unable to provide convincing evidence as to the rate of return to be used for this project, MMS will set the rate of return at 8%. The MMS approved rate of return shall be applied in accordance with MMS procedures.

penditures to be amortized will be adjusted to account for costs recovered through salvage, tax credits, and tax advantages resulting from depreciation deductions.

The net unit value for royalty purposes will be calculated using the gross price as determined at the point of sale, operating costs, and the initial investment and development costs adjusted for additions and deletions in the expenditure categories for pipelining, liquefaction, storage, and tankering.

Ratio (1) above represents a manufacturing and transportation allowance to be deducted by Marathon from the sales value. The unit value at the point of sale shall be multiplied by the quantity, one minus ratio (1). This unit sales value is further reduced by subtracting ratio (2) to allow for pipelining costs from the lease to the LNG plant.

Marathon will be responsible for making all calculations and submitting an annual allowance proposal to the Minerals Management Service. Detailed procedures for making these calculations will be provided to Marathon by the MMS. These calculations will be subject to review and audit.

D. ORDERS CONCERNING REHEARING

1. Ninth Circuit Order Issued July 25, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees.*	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	ORDER

Appeal from the United States
District Court for the District of Alaska

Before: WALLACE, Circuit Judge.

The opinion in this case is to be temporarily withheld from publication in any bound volume, including the bound volume of Federal Reporter of West Publishing Company, until further order. A slip opinion may be circulated and the opinion may be cited.

2. Ninth Circuit Order Issued August 20, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees,*	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	ORDER

Appeal from the United States
District Court for the District of Alaska

Before: WRIGHT AND WALLACE, Circuit Judges, and LEGGE,* District Judge.

Counsel for Marathon assert that our order which temporarily withholds the case from "publication in any bound volume," and which also specifically states that the opinion may be cited, misled counsel into believing that some change may be made in the opinion. There is nothing in the order that affects

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

the authenticity of the opinion, and it obviously relates to whether it will be published at that time "in any bound volume."

Marathon's request for an extension of time to file a "motion for rehearing or rehearing *en banc*" until 14 days from the date an order is entered allowing the opinion to be published is denied.

3. Ninth Circuit Order Issued September 3, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees.*	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	ORDER

Appeal from the United States
District Court for the District of Alaska

Before: WRIGHT AND WALLACE, Circuit Judges, and LEGGE,* District Judge.

The motion filed by Marathon for clarification of our order dated August 20, 1986, is denied. Our order is clear.

If Marathon wishes to file a motion for leave to file a late petition for rehearing and suggestion for rehearing *en banc*, it should do so promptly with supporting papers demonstrating why such leave should be granted.

---

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

4. Ninth Circuit Order Issued September 30, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees,*	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	ORDER

Appeal from the United States
District Court for the District of Alaska

Before: WRIGHT AND WALLACE, Circuit Judges, and LEGGE,* District Judge.

The petition for rehearing and suggestion for rehearing *en banc* lodged by Marathon Oil Company is ordered filed.

---

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

5. Ninth Circuit Order Issued September 30, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees.*	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	ORDER

Appeal from the United States
District Court for the District of Alaska

Before: WRIGHT AND WALLACE, Circuit Judges, and LEGGE,* District Judge.

The government is requested to file within twenty-one (21) days from the date of this order a response of not over fourteen (14) pages to the petition for rehearing and suggestion for rehearing *en banc* of Marathon Oil Company. The response should be directed to part I of the petition. The government should include its position as to the sufficiency of the administrative record in general, and in support of any finding that liquid natural gas is equivalent to natural gas, whether this issue was properly raised and preserved in the district court, and whether it was properly raised on this appeal. Proper citations to the record should be included.

---

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

6. Ninth Circuit Order Issued November 13, 1986.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARATHON OIL COMPANY, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *et al.* *Defendants-Appellees.*	)	No. 85-3800 DC# A83-208 Civil
COOK INLET REGION, INC., *Counterclaimant,* vs. MARATHON OIL COMPANY, *Counterdefendant.*	)	ORDER

Before: WRIGHT AND WALLACE, Circuit Judges, and LEGGE,* District Judge.

Appellant's reply to the response of the United States to the petition for rehearing and suggestion for rehearing *en banc*, already received, shall be filed.

---

* Honorable Charles A. Legge, United States District Judge, Northern District of California, sitting by designation.

(3)

Supreme Court, U.S.
FILED
FEB 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1006

In the Supreme Court of the United States

OCTOBER TERM, 1986

MARATHON OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

CHARLES FRIED
Solicitor General

F. HENRY HABICHT II
Assistant Attorney General

JACQUES B. GELIN
ROBERT L. KLARQUIST
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

15 P

QUESTION PRESENTED

Whether, under a longstanding regulation and federal mineral lease provisions that require royalties to be paid on no less than the "gross proceeds" accruing to a lessee from the sale of natural gas production from federal leases, the Secretary of the Interior may value certain gas, which the lessee produces from federal leases and sells in Japan as liquefied natural gas, on the basis of the landed sales price that petitioner receives in Japan, less allowable costs and deductions for liquefaction and transportation (including return on investment).

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	12

TABLE OF AUTHORITIES

Cases:

Ashland Oil, Inc. v. *Phillips Petroleum Company*, 554 F.2d 381 (10th Cir. 1975), cert. denied, 434 U.S. 921 (1977)	9
California Co. v. *Udall*, 296 F.2d 384 (D.C. Cir. 1961)	3
Chevron U.S.A. Inc. v. *NRDC*, 467 U.S. 837 (1984)	11
Continental Oil Co. v. *United States*, 184 F.2d 802 (9th Cir. 1950)	9
Udall v. *Tallman*, 380 U.S. 1 (1965)	11
United States v. *National Bank of Commerce*, 472 U.S. 713 (1985)	10
United States v. *Riverside Bayview Homes*, No. 84-701 (Dec. 4, 1985)	11

Statutes and regulations:

Alaska Native Claims Settlement Act, 43 U.S.C. 1601 *et seq.*	3
§ 14(g), 43 U.S.C. 1631(g)	3
Mineral Leasing Act of 1920, 30 U.S.C. 181 *et seq.*	2
§ 17(c), 30 U.S.C. 226(c)	2, 7
§ 32, 30 U.S.C. 189	2, 7, 11
§ 35, 30 U.S.C. 191	5
30 C.F.R. 206.103	3, 4, 11

Miscellaneous:

7 Fed. Reg. (1942):	
p. 4132	2
p. 4137	2, 8
R. Hemingway, *The Law of Oil and Gas* (1971 & Supp. 1979)	8, 9

In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1006

MARATHON OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2a-17a) is reported at 807 F.2d 759. The opinion of the district court (Pet. App. 22a-53a) is reported at 604 F. Supp. 1375.

JURISDICTION

The judgment of the court of appeals was entered on July 24, 1986 (Pet. App. 2a). A petition for rehearing, although not timely filed, was ordered filed by the court of appeals (see Pet. App. 79a) and was denied on January 22, 1987. On October 3, 1986, Justice O'Connor extended the time for filing a petition for a writ of certiorari to and including December 21, 1986. The petition was filed on December 19, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Mineral Leasing Act of 1920, 30 U.S.C. 181 *et seq.* ("the Act"), authorizes the Secretary of the Interior, among other things, to lease public domain lands for oil and gas production. Section 17(c) of the Act, 30 U.S.C. 226(c), provides that "[s]uch leases shall be conditioned upon the payment by the lessee of a royalty of 12½ per centum in amount or value of the production removed or sold from the lease."

The Secretary is authorized by Section 32 of the Act, 30 U.S.C. 189, "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of" the Act. Pursuant to this authority, the Secretary issued the following regulation in 1942 (7 Fed. Reg. 4132, 4137 (emphasis added)):

> § 221.47 *Value basis for computing royalties.* The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. *Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof* or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products pro-

> duced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

This regulation has been in force without substantive change ever since, and is now codified at 30 C.F.R. 206.103.

2. Since the 1950s, petitioner has owned working interests in seven federal oil and gas leases within the Kenai Unit in Alaska.[1] Among other things, the leases expressly require the lessee to pay a royalty computed in accordance with the Oil and Gas Operating Regulations, including what is now 30 C.F.R. 206.103. The leases further state that the lessee has "expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on * * * gas" removed or sold from the leased lands. The statute, regulations, and lease terms thus grant the Secretary the authority to determine reasonable value for royalty purposes. See C.A. Excerpts of Record Exh. A; *California Co.* v. *Udall*, 296 F.2d 384 (D.C. Cir. 1961).

Petitioner transports a portion of its share of the gas produced from the federal leases to a liquefied natural gas (LNG) plant at Nikiski, Alaska. The gas is then cooled to a liquid state, loaded on petitioner's tanker vessels, and shipped to Japan, where it is delivered and sold to Japanese public utility customers. Thus, the first sale of the gas does not occur until it is delivered in Japan. Pet. App. 3a.

---

[1] Because of conveyances of certain lands to Cook Inlet Region, Inc. (CIRI), an Alaska Native Regional Corporation established pursuant to the Alaska Native Claims Settlement Act (ANCSA), 43 U.S.C. 1601 *et seq.*, CIRI is entitled to approximately 65 percent of the royalties from oil and gas produced on the leases, with the remaining 35 percent going to the United States. The federal government has retained administration of the leases pursuant to Section 14(g) of ANCSA, 43 U.S.C. 1613(g).

Since the mid-1970s, petitioner and the government have been involved in a dispute concerning the royalty value of the Kenai Unit gas that petitioner sells in Japan. First the United States Geological Survey (USGS), and now its successor agency the Minerals Management Service (MMS), Department of the Interior, have maintained that, under 30 C.F.R. 206.103, the royalty value cannot be less than petitioner's "gross proceeds," *i.e.*, the sale price that petitioner receives on the initial sale of the gas in Japan, less allowances for liquefaction and transportation (including a return on investment). Petitioner, however, has asserted that the sale price that it obtains in Japan has no relevance to royalty value and claims that the royalty value of the LNG volumes must be determined by reference to the prices paid by local Alaskan gas customers for other gas produced from the federal leases. Pet. App. 24a.

In an effort to resolve this dispute, petitioner and the USGS agreed in 1981 to a method of determining royalty value based on petitioner's sale price for LNG in Japan, reduced by a fixed percentage (and subject to various adjustments). This agreement, however, was subject to termination in the event of changed market conditions or other factors. Pet. App. 4a.

In fact, market conditions changed shortly after the agreement was entered. In 1983, MMS notified petitioner that it intended to redetermine prospectively the reasonable royalty value for the Kenai Unit gas sold in Japan (Pet. App. 71a). Under that revision, petitioner would be required to compute its gross proceeds, for royalty calculation purposes, based on the sales price in Japan less its actual costs for liquefaction and transportation, including a return on its investment (*id.* at 64a-70a).[2]

---

[2] The procedure proposed by MMS described the deductible element "Return on Investment" as follows (Pet. App. 70a):

> The lessee shall present to MMS a proposed reasonable rate of

Following a public hearing, MMS determined that the royalty value should be computed in the manner previously proposed to petitioner. Accordingly, on July 8, 1983, MMS directed petitioner to calculate royalty values according to the gross proceeds methodology set forth in its prior letter to petitioner (*id.* at 61a-63a). That methodology, which takes as its starting point the actual sales price received by petitioner in Japan and then "works backwards" by allowing various deductions to arrive at the value of the gas at the leasehold, has been referred to in this proceeding as a "net-back" formula.

3. Petitioner did not comply with the order of July 8, 1983, or supplementary MMS orders.[3] Rather, in 1983, petitioner initiated this action against the United States and other federal parties, the State of Alaska and a state officer,[4] and CIRI. Petitioner sought judicial review of

---

return for this type of operation in the Alaska region at the time covered by this project. This proposal shall identify all components such as risk, cost of capital, etc., that are incorporated in this rate. If the lessee is unable to provide convincing evidence that their proposed rate of return is reasonable, MMS will fix a value and advise Marathon of the rate of return to be used.

[3] Even before MMS issued its order of July 8, 1983, petitioner had stopped calculating royalties on the basis of the compromise methodology that had been in effect since 1981. Instead, petitioner began to compute and pay royalties on the gas sold in Japan based on a value of production equal to the prevailing sales price under a 1975 gas sales agreement amendment with a local Alaskan customer, thereby unilaterally rolling back its royalty payments by almost two-thirds. In October 1983 and June 1984, MMS issued further orders directing petitioner to pay certain amounts of underpaid royalties and to comply with MMS's previous orders. Petitioner did not comply with any of the orders. Pet. App. 54a-60a.

[4] Under Section 35 of the Mineral Leasing Act, 30 U.S.C. 191, the State of Alaska is entitled to 90 percent of the royalties received by the United States from the federal leases.

MMS's orders concerning petitioner's royalty obligations and requested a judgment declaring that it "may compute royalties on the natural gas produced from the Leases which is supplied to the LNG Plant on the basis of the highest field market price paid under arms-length sales of natural gas in the Kenai Field to Alaska purchasers." Second Amended Complaint at 23.

The district court entered an opinion and order in favor of the defendants (Pet. App. 22a-53a). The district court, stating that its primary task in this case was to ascertain whether MMS's orders constituted a reasonable interpretation of the Mineral Leasing Act and the implementing regulations (*id.* at 30a), held, among other things, that "the MMS orders directing Marathon to use the net back method fall within the agency's authority under the statutes and regulations" and are also consistent with the terms of the leases (*id.* at 45a). In particular, the court "agree[d] with [petitioner's] basic premise" that royalties should be based on the value of production *at the lease*, but held that the net-back method was an appropriate method for determining that value (*id.* at 43a). Accordingly, the court granted summary judgment to the United States and dismissed petitioner's claims against the United States (*id.* at 18a-21a). The court directed petitioner to pay royalties in accordance with MMS's orders and retained jurisdiction to conduct accounting proceedings (*ibid.*).

The court of appeals affirmed (Pet. App. 2a-17a). The court of appeals upheld the district court's ruling concerning the validity of MMS's net-back valuation formula for the reasons stated in the district court's opinion (*id.* at 10a-11a). The court also rejected various other arguments that had not been explicitly addressed in the district court's opinion (*id.* at 11a-17a).

ARGUMENT

The decision of the court of appeals is correct, conflicts with no decision of this Court or any other court of appeals, and presents no issue of general importance warranting review by this Court. Accordingly, the petition should be denied.

1. Petitioner's primary argument (Pet. 7-13) is that the Mineral Leasing Act itself somehow precludes use of the net-back methodology, and that the courts below therefore erred in accepting the agency's interpretation of the Act even if it was otherwise reasonable. Petitioner's argument proceeds, in its entirety, from Congress's use of the word "royalty" in Section 17(c) of the Act, which petitioner says means a percentage of the actual production or its value at the lease (Pet. 10). The simple answer is that, as the district court noted (Pet. App. 43a), the net-back methodology is a means of determining value at the lease. There is no evidence whatsoever that Congress considered the question presented in this case—how to value production at the lease when the first sale takes place elsewhere after further processing and transportation—and determined that a net-back methodology was inappropriate. In these circumstances, and in light of the broad delegation of authority in Section 32 of the Act, the courts below appropriately deferred to the agency's reasonable interpretation.[5]

---

[5] There is no substance to petitioner's contention that the courts below erred by not "*explicitly* find[ing], as a matter of law, that the statute and legislative history are ambiguous on the disputed issue" (Pet. 9 (emphasis added)). Petitioner does not point to anything in the statute or legislative history that unambiguously resolves the question presented in this case. In the absence of any colorable claim along those lines, petitioner's argument amounts to nothing more than a suggestion that courts err when they draw correct conclusions about statutory language and legislative history implicitly rather than explicitly. This Court's decisions do not mandate the formalistic approach for which petitioner contends.

Petitioner asserts, in substance, that the Mineral Leasing Act states that the government may collect a "royalty" on gas production from federal lands leased under the Act, that here the Secretary has attempted to assess a "net-profits interest" instead of a "royalty," and that the courts below erred by deferring to the Secretary's interpretation of the Act as allowing him to impose a "net-profits interest" instead of a "royalty." Pet. 11-12. Petitioner's position is without merit.

As we have shown (page 3, *supra*), the leases in question expressly provide that they are subject to MMS's regulations and that petitioner agrees that the Secretary of the Interior "may establish reasonable minimum values for the purposes of computing royalty on * * * gas" removed or sold from the leases. The applicable regulation, which has been in force for 45 years and at all times since the leases were entered, provides that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof." 7 Fed. Reg. 4137 (1942). Hence, under the terms of the regulation and leases, the royalty value may be no less than the lessee's gross proceeds, regardless of what may be the generally prevailing market price in that area. A provision obligating the lessee to pay a share of gross proceeds is a "royalty" interest. R. Hemingway, *The Law of Oil and Gas* § 7.4, at 316, 320-321 (1971 & Supp. 1979).

If petitioner sold its production at the leasehold, its "gross proceeds" would be simply the amount that it received from the purchaser. Petitioner, however, sells its production for the first time on delivery in Japan rather than at the leasehold. Accordingly, as the district court correctly observed (Pet. App. 40a-41a, 45a), it was necessary for MMS to devise a method for calculating the gross proceeds value of the production at the leasehold. The methodology that MMS has adopted to make this cal-

culation starts with the actual sale price that petitioner receives in Japan and then makes allowances for costs of transportation and liquefaction (including a return on investment) to arrive at the gross proceeds value of the gas at the leasehold.

As the courts below noted (Pet. App. 11a, 40a), such a "net-back" method of ascertaining royalty value is well established and accepted in the industry. "Royalty payable upon the 'proceeds' of the sale of gas, will be computed on the basis of aggregate gross receipts from all products, less the costs of marketing and transportation. The presence of actual sales in the field is immaterial." R. Hemingway, *supra,* § 7.4, at 316. As the Tenth Circuit has observed:

> The work-back valuation is well recognized in the production and early processing of natural gas. It is commonly used, according to this record, in placing a value on feed stock for gasoline plants and related processing. There is nothing unusual about the method, it is subject to proof, and can be just as accurate as any other method, but it is more difficult to apply.

Ashland Oil, Inc. v. *Phillips Petroleum Company,* 554 F.2d 381, 387 (1975), cert. denied, 434 U.S. 921 (1977); see also *Continental Oil Co.* v. *United States,* 184 F.2d 802, 820-821 (9th Cir. 1950).

Petitioner inaccurately represents (Pet. 5) that the Secretary conceded in the court of appeals that the government was attempting to levy a "profit-sharing interest" rather than a "royalty." At no point did the government ever state or imply that it was seeking to collect other than, or more than, a "royalty" interest. Of course, whenever a lessee sells its production at a price greater than the commonly prevailing local market price, the lessor, under a "gross proceeds minimum" lease (as contrasted to a pure market value lease), will "share" in such "entrepreneurial profits" in the sense that the lessor has a stake in the

lessee's receipts. That result, however, does not transform a gross proceeds provision from a royalty interest into a net profit share interest.[6]

2. Petitioner lists a number of factors that courts consider in determining the amount of deference owed to an agency's interpretation of a statute it is charged with administering (Pet. 14-17). For the most part, we agree with petitioner that the factors it lists are appropriate.[7] Those factors support the deference given to MMS in this case.

Certainly the amount of deference given an agency is greatest when the delegation of authority is broad (Pet.

---

[6] As petitioner points out (Pet. 11), in the mining industry a "royalty" is a cost-free share of production whereas a "net-profits interest" is a share of profits from production after costs have been deducted. Here, the leases at issue require that production be valued for royalty purposes at no less than the gross proceeds accruing to the lessee. Under these leases, the lessee's costs of production at the leasehold are irrelevant and the amounts that the lessee must pay the government are not tied to the lessee's profits. Indeed, the lessee would remain obligated to pay a 12½ percent royalty on its gross proceeds even if it were making no net profit whatsoever. And, as we have pointed out (pages 4-5, *supra*), the royalty valuation methodology at issue specifically entitles the petitioner to deduct such rate of return on its investment in its liquefaction and transportation facilities (including risk) as it may show to be reasonable.

[7] Petitioner, however, incorrectly claims (Pet. 17) that MMS's interpretation of the Mineral Leasing Act is entitled to less deference in this case because the government has a "pecuniary interest" in the amount of royalties to be collected. The cases on which petitioner relies are due process cases indicating that a decisionmaker should not have a *personal* financial stake in the outcome of the proceeding and are obviously inapposite. Indeed, if petitioner's argument were correct, the Internal Revenue Service, which is always "a collection agency for the Treasury" (*ibid.*), would not be entitled to deference in its interpretation of the Internal Revenue Code, yet this Court has not hesitated to give "considerable deference" to the IRS's interpretation of the Code. *United States* v. *National Bank of Commerce*, 472 U.S. 713, 730 (1985).

14-15). In this case, Section 32 of the Act constitutes a very broad delegation of authority to do that which is "necessary and proper."

The agency's expertise is also an important factor (Pet. 15). Although petitioner suggests otherwise, we do not think that it can be seriously disputed that MMS and the Department of the Interior have expertise in matters of oil and gas law in general and interpretation of the Mineral Leasing Act and leases thereunder in particular. See *Udall* v. *Tallman,* 380 U.S. 1, 16 (1965) (deferring to interpretation of Mineral Leasing Act by Secretary of the Interior).[8]

Finally, the "timing and consistency" (Pet. 15) of MMS's interpretation of the statute, and other factors petitioner lists (Pet. 15-17), are also consistent with the deference granted by the courts below. The "gross proceeds" provision of 30 C.F.R. 206.103, which virtually requires use of the net-back methodology in this case, has been part of the agency's consistent interpretation of the Act for 45 years. In addition, the court of appeals, referring to its 35-year-old decision upholding a closely analogous ruling by the Secretary of the Interior in a Mineral Leasing Act royalty dispute, stated that "[t]his is not the first time we have concluded that it is not unreasonable for the Secretary to use a net back or net realization formula to compute the value of production for royalty purposes" (Pet. App. 11a (citing *Continental Oil Co.* v. *United States, supra*)). Similarly, the district court, whose reasoning was adopted by the court of appeals (Pet. App. 11a), rejected petitioner's contentions that the net-back formula at issue was inconsistent with

---

[8] Petitioner remarkably suggests that *Chevron U.S.A. Inc.* v. *NRDC,* 467 U.S. 837 (1984), "implicitly rejected the approach taken in some earlier cases" (Pet. 8) including *Udall* v. *Tallman.* Just the opposite is true. *Chevron* reiterated "well-settled principles" (467 U.S. at 845) culled from such cases as *Udall* v. *Tallman,* which was cited in 467 U.S. at 843 n.11. See, *e.g., United States* v. *Riverside Bayview Homes,* No. 84-701 (Dec. 4, 1985), slip op. 9-10.

previous Interior practices (*id.* at 36a-39a, 44a), found the agency's methodology to be "a reasonable method for establishing a basis for computing royalties" (*id.* at 44a), and concluded that "the MMS orders directing Marathon to use the net back method fall within the agency's authority under the statutes and regulations" (*id.* at 45a).

In short, the courts below did not simply "rubber stamp" the Secretary's position but, after examination of the statute, the applicable regulation, and the leases themselves, determined that the agency had reached a reasonable interpretation entitled to deference in the circumstances of this case. That conclusion was correct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

F. HENRY HABICHT II
Assistant Attorney General

JACQUES B. GELIN
ROBERT L. KLARQUIST
Attorneys

FEBRUARY 1987

U.S. GOVERNMENT PRINTING OFFICE: 1986—181-483/40223

MOTION FILED
FEB 23 1987

No. 86-1006

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

MARATHON OIL COMPANY,
an Ohio corporation,
Petitioner,
v.

UNITED STATES OF AMERICA, UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE OF THE AMERICAN PETROLEUM INSTITUTE

Of Counsel
THOMAS L. CUBBAGE II
1256 Adams Building
Bartlesville, OK 74004

G. WILLIAM FRICK
(Counsel of Record)
DAVID T. DEAL
PHILIP A. COONEY
AMERICAN PETROLEUM INSTITUTE
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8246
Counsel for Amicus Curiae

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1006

MARATHON OIL COMPANY,
an Ohio corporation,
Petitioner,

v.

UNITED STATES OF AMERICA, UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior: ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

MOTION OF AMERICAN PETROLEUM INSTITUTE FOR PERMISSION TO FILE BRIEF AMICUS CURIAE

Amicus Curiae American Petroleum Institute (API) respectfully moves the Court to grant it leave to file a brief in support of the Petition for a Writ of Certiorari in the captioned matter. API moves for such leave on the following grounds:

1. All parties to this litigation have consented to API's participation as *amicus curiae*, with the exception of Respondent Cook Inlet Region, Inc. (CIRI).

2. On December 31, 1986, API requested the consent of all parties, including CIRI. It was not until February 19, 1987 that counsel for CIRI, by telephone, denied this request. Such denial followed API's receipt of the consent of Petitioner Marathon and Respondents, the United States of America and the State of Alaska.

3. CIRI consented, along with the other parties, to API's participation in the United States Court of Appeals for the Ninth Circuit as *amicus curiae.*

4. API is a national trade association whose over 200 company members represent all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. Many of API's members are actively engaged in the acquisition and development of federal oil and gas leases and are, therefore, directly affected by policies for valuation of natural gas production for royalty purposes. In this regard, API's member companies have a significant interest in the outcome of this litigation. API has already participated as *amicus curiae* in the proceedings below in the United States Court of Appeals for the Ninth Circuit. Moreover, API has participated in other litigation before this Court involving the calculation of royalties on oil and gas leases. *See, e.g., Ashland Oil, Inc. v. Good,* Nos. 83-1234, 83-1248 and 83-1278; *Kewanee Oil Co. v. Holmes,* No. 83-1250.

WHEREFORE, *amicus curiae API* respectfully moves the Court to grant API leave to file its brief in Support of the Petition for a Writ of Certiorari.

Respectfully submitted,

G. WLLIAM FRICK
(Counsel of Record)
Attorney for American Petroleum Institute

February 23, 1987

QUESTION PRESENTED

Whether the Department of the Interior, through application of the netback method for product valuation, has unlawfully expanded the commercially understood meaning of the statutory terms "production" and "royalty", thereby apportioning to itself a share of downstream entrepreneurial value in its royalty assessment?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	iv
INTEREST OF THE AMICUS CURIAE	1
ARGUMENT	3
I. The Decision Below Poses Statutory Construction Issues of Fundamental Significance Regarding Future Federal Royalty Management Decisions	3
II. The Ninth Circuit Decision Permits DOI Royalty Collection to Undercut Federal Policies Encouraging Domestic Energy Production	9
III. Resolution of This Issue Now Is Timely	12
CONCLUSION	15

TABLE OF AUTHORITIES

CASES Page

Ashland Oil & Refining Co. v. Staats, 271 F. Supp. 571 (D. Kan. 1967) 14
Ashland Oil, Inc. v. Phillips Petroleum, 554 F.2d 381 (10th Cir. 1975) 6
Ashland Oil, Inc. v. Phillips Petroleum, 463 F. Supp. 619 (N.D. Okla. 1978), *rev'd on other grounds*, 607 F.2d 335 (10th Cir. 1979) 7
Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378 (1959) 10
Barby v. Cabot Corp., 465 F.2d 11 (10th Cir. 1972) 5
Board of Governors v. Dimension Financial Corp., —— U.S. ——, 106 S. Ct. 681 (1986) 4
California v. Southland Royalty Co., 436 U.S. 519 (1978) 10
Chevron, U.S.A. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 9
Federal Power Commission v. Panhandle Eastern Pipe Line Co., 337 U.S. 498 (1949) 4
Federal Power Commission v. Texaco, Inc., 417 U.S. 380 (1974) 10
FERC v. Pennzoil Producing Co., 439 U.S. 508 (1979) 9
Harvey v. Udall, 384 F.2d 883 (10th Cir. 1967) 10
In Re Permian Basin Area Rate Cases, 390 U.S. 747 (1968) 9
James Petroleum Corp. v. Commissioner, 238 F.2d 678 (2d Cir. 1956) 5
Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934) 5
Marathon Oil Co. v. United States, 807 F.2d 759 (9th Cir. 1986) 2, 12, 13
Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985) 2, 12, 13
Martin v. Glass, 571 F. Supp. 1406 (N.D. Tex. 1983) 6
Mesa Petroleum Co. v. U.S. Department of Interior, 647 F. Supp. 1350 (W.D. La. 5

TABLE OF AUTHORITIES—Continued

	Page
Monsanto Co. v. Tyrell, 537 S.W.2d 135 (Tex. Civ. App. 1976, *writ ref'd n.r.e.*)	5
Northern Natural Gas Co. v. Grounds, Memorandum of Opinion, "The Workback Method," (D. Kan.), Oct. 18, 1983	7
Northern Natural Gas Co. v. State Corp. Commission of Kansas, 372 U.S. 84 (1963)	4
Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944)	6
Phillips Petroleum Co. v. Record, 146 F.2d 485 (5th Cir. 1944)	5
Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984)	5
Public Service Commission v. Mid-Louisiana Gas Co., 463 U.S. 319 (1983)	10
Union Oil Co. of California v. Touchet, 86 So. 2d 50 (La. 1956)	5
United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946), *aff'd sub nom. Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950)	4
United States v. Ohio Oil, 163 F.2d 633 (10th Cir. 1947)	13
United States v. Wichita Industries, 390 F. Supp. 1154 (W.D. Okla. 1974)	14

STATUTES

Mineral Lands Leasing Act, as amended,	
30 U.S.C. §§ 181-287 (1982)	3, 10
30 U.S.C. § 226(b) (1982)	4
30 U.S.C. § 226(c) (1982)	3
Natural Gas Policy Act of 1978	
15 U.S.C. §§ 3301 et seq. (1982)	10
Outer Continental Shelf Lands Act, as amended,	
43 U.S.C. §§ 1331 et seq. (1982)	4, 11
43 U.S.C. § 1337 (1982)	4, 8

TABLE OF AUTHORITIES—Continued

	Page
43 U.S.C. § 1337(a) (1) (D-(F) (1982)	8
43 U.S.C. § 1801 (1)-(4) (1982)	11
43 U.S.C. § 1802 (1) (1982)	11
REGULATIONS	
30 C.F.R. § 206.103 (1986)	12
Advance Notice of Proposed Rulemaking, 51 Fed. Reg. 4507 (Feb. 15, 1986)	14
Notice of Proposed Rulemaking, 52 Fed. Reg. 1858 (Jan. 15, 1987)	14
52 Fed. Reg. 4732 (Feb. 13, 1987)	14
MISCELLANEOUS	
R. Hemingway, *The Law of Oil and Gas*, § 2.5 (2d ed. 1983)	5, 14
Leftwich and Yu, *The Workback Method of Valuing Raw Materials: The Helium Cases*, Oil & Gas Tax Quarterly, December 1986, Volume XXXV, No. 2	7
Mineral Revenues: The 1985 Report on Receipts From Federal and Indian Leases, United States Department of Interior, Minerals Management Service, Royalty Management Program, Table 2	3
Sneed, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 Tex. L. Rev. 641 (1947)	5
Solicitor's Opinion M-36888 (October 4, 1976), 84 I.D. 171 (1977)	5
3 Williams, *Oil & Gas Law*, Express Clauses of Oil & Gas Leases, § 643 (1982)	6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1006

MARATHON OIL COMPANY,
an Ohio corporation,
Petitioner,

v.

UNITED STATES OF AMERICA, UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF AMICUS CURIAE OF THE AMERICAN PETROLEUM INSTITUTE

INTEREST OF THE AMICUS CURIAE

The American Petroleum Institute ("API") submits this brief as *amicus curiae* in support of the petition for writ of certiorari in No. 86-1006. The petition seeks review of a judgment of the United States Court of Appeals for the Ninth Circuit. *Marathon Oil Company*

v. United States, 807 F.2d 759 (9th Cir. 1986). That court affirmed the district court, which had upheld the Department of the Interior's (DOI) application of the netback method to value natural gas for federal royalty purposes. *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alaska 1985).

API's position is that this valuation method yields a royalty far in excess of that to which the federal government is entitled under the Minerals Lands Leasing Act. In addition, the netback method as applied in this case raises producers' costs of production, contrary to the policies embodied in federal leasing statutes and other laws. Plenary review by this Court is especially timely in that it would properly define the legal bounds of DOI's authority to collect royalties, a central issue in its pending overhaul of the product valuation regulations.

API is a national trade association whose over 200 company members represent all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. Many of API's members are actively engaged in the acquisition and development of federal oil and gas leases and are, therefore, directly affected by policies for valuation of natural gas production for royalty purposes.

API routinely participates on industry's behalf in legislative, administrative, and judicial proceedings where issues of national significance are presented. This case presents such an issue. Through application of the netback method for product valuation, DOI has expanded the commercially understood meaning of the statutory terms "production" and "royalty", thereby apportioning to itself a share of downstream entrepreneurial value in its royalty assessment. DOI's use of netback valuation methodology has produced an unfair and unlawful result for petitioner Marathon and has significant implications for other producers of natural gas and crude oil who hold federal leases.

REASONS FOR GRANTING THE WRIT

I. The Decision Below Poses Statutory Construction Issues of Fundamental Significance Regarding Future Federal Royalty Management Decisions

The Government's position relies on an unlawful construction of the terms "royalty" and "production" which goes to the heart of every royalty decision. Both the immediate enforcement of this flawed construction and the prospect of setting erroneous legal precedent involve alteration of the financial terms agreed to by the federal government and federal oil and gas lessees. Even the most subtle alteration in the terms underlying this business relationship would necessarily affect the disbursement of an enormous sum of money. In 1985 alone, the most recent year for which such data is available, federal oil and gas lessees paid to the Federal Government $4.54 billion in royalties.[1]

Federal lessees make a multitude of finely calculated decisions based on the anticipated returns from entering the federal leasing relationship. DOI's unlawful imposition of the netback method for product valuation retroactively alters the business terms of the leasing relationship to the government's advantage, with the unfortunate effect of introducing elements of unpredictability and reduced incentive in the federal leasing relationship.

The authority of the Secretary of the Interior to lease onshore federal lands is set forth in the Mineral Lands Leasing Act. 30 U.S.C. §§ 181 et seq. (1982). The Act reserves to the federal government a "royalty of 12½ per centum in *amount or value of the production removed or sold from the lease.*" (emphasis supplied). 30

---

[1] Mineral Revenues: The 1985 Report on Receipts From Federal and Indian Leases, United States Department of Interior, Minerals Management Service, Royalty Management Program, Table 2. In 1984, federal oil and gas lessees paid royalties of $4.91 billion.

U.S.C. § 226(c) (1982).[2] In this case, DOI has given lip service at best to the lawful meaning of the terms "royalty" and "production"; however, in applying the netback method, DOI has relied on a far broader and, therefore, unlawful interpretation of those terms. In *Board of Governors v. Dimension Financial Corp.*, —— U.S. ——, 106 S. Ct. 681 (1986), this Court invalidated the interpretation of a statutory term by a federal agency because "[n]othing in the statutory language or the legislative history . . . indicate[d] that the term . . . meant anything different from its accepted ordinary commercial usage." *Id.* at 689.

Whether the Secretary elects to take royalty in "amount" or "value", the "production" to which both refer is necessarily at the lease. Although the term "production" is not expressly defined by the Mineral Lands Leasing Act, its established commercial meaning in state and federal oil and gas law confirms that it refers exclusively to withdrawn substances at the leasehold.[3] It

---

[2] Marathon's lease is a so-called "noncompetitive lease." For leases acquired by competitive bidding, the Act's royalty provision is very similar: royalty shall be "not less than 12½ per centum in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(b) (1982).

The Outer Continental Shelf Lands Act, 43 U.S.C. § 1331 et seq. (1982) confers DOI's offshore leasing authority and similarly requires a royalty equal to a specified percentage "in amount or value of the production saved, removed, or sold from the lease." 43 U.S.C. § 1337.

[3] "Production" is a well-understood commercial term in the oil and gas industry. See Northern Natural Gas Company v. State Corp. Commission of Kansas, 372 U.S. 84, 90 (1963) (the term "production" is narrowly confined to the physical acts of drawing gas from the earth and preparing it for first stages of distribution); Federal Power Commission v. Panhandle Eastern Pipe Line Company, 337 U.S. 498, 518 (1949) (clear and natural meaning of production is the act of bringing forth gas from earth and preparing it for first stages of distribution); United States v. General Petroleum Corp., 73 F. Supp. 225, 254 (S.D. Cal. 1946), (stating

follows that royalty is due only on the value of actual production at the wellhead.

Similarly, commentators have never questioned the fact that a "royalty" is only a passive right to receive a portion of the production from a lease, either in kind or in value.[4] A "royalty" does not include a share in any downstream enhancement of value.[5] As Professor Williams

---

that "Natural gas royalties are payable on gas as it is produced at the well. It is the value of gas that must be determined.") *aff'd sub nom.*, Continental Oil Company v. United States, 184 F.2d 802 (9th Cir. 1950); Mesa Petroleum Co. v. U.S, Department of Interior, 647 F. Supp. 1350 (W.D. La. 1986) ("[T]he United States is entitled to royalties as the minerals within the leased area are depleted."); Solicitor's Opinion M-36888 issued October 4, 1976, 84 I.D. 171 (1977) ("production," as used in all federal oil and gas leases includes oil and gas withdrawn from a reservoir). Union Oil Co. of California v. Touchet, 86 So.2d 50, 53 (La. Sup. 1956) (Royalty is a right to share in production of gas, if and when it is produced from the property subject to the royalty); Monsanto Co. v. Tyrell, 537 S.W.2d 135 (Tex.Civ.App. 1976, *writ ref'd. n.r.e.*) (Under Texas law, "production" means the actual physical extraction of the mineral from the soil.)

[4] *See, e.g.*, R. Hemingway, *The Law of Oil and Gas* § 2.5, at 52 (2d ed. 1983); Sneed, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 Tex. L. Rev. 641, 648, 650 (1947).

[5] *See* Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934) (the United States as lessor is not entitled to a share of the profits [or proceeds of sales] delivered from products extracted from gas after it is delivered into a pipeline at the sales point; a lessor's rights are measured and cease at the sales point). *See also* Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 231 (5th Cir. 1984) (the royalty compensates the lessor for the value at the well before the lessee adds value to the gas by processing it); Barby v. Cabot Corp., 465 F.2d 11, 15 (10th Cir. 1972) (the royalty owner tied his royalty payment to the market value of the natural gas at the wellhead and is precluded from contending that royalties are due on the end products after processing); James Petroleum Corp. v. Commissioner, 238 F.2d 678 (2d Cir. 1956) ("An oil royalty interest is only a right to share in oil and gas if and when produced. . . .") Phillips Petroleum Co. v. Record, 146 F.2d 485, 486 (5th Cir. 1944) (a right to receive one-

succinctly observed, a royalty "does not depend on the use the operation in fact makes of the gas produced, but upon the market value thereof." [6]

The district and appellate courts below both purported to accept this fundamental premise, then inconsistently approved a valuation methodology—netback (sometimes called workback)—which as applied in this case unlawfully captures the value added downstream by the lessee, Marathon. In transporting its natural gas production from the lease to its nearby LNG manufacturing plant, Marathon did not enter into a sale. On the other hand, comparable sales of the same gas from the same field and in substantial quantities did occur.[7] Notwithstanding the ready availability of this sound measure of value, DOI chose to use netback, a far more uncertain measure of value, which in this case yielded both unfair and unlawful results. Even those courts which have considered the use of the netback valuation technique have recognized its methodological shortcomings.[8] Indeed, some com-

---

eighth of the gross proceeds does not entitle a royalty owner to receive one-eighth of the market value of the product manufactured from that gas); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138, 141 (5th Cir. 1944) (the royalty owner is entitled to be paid on the basis of the market value of the natural gas at the well without regard to the use the lessee makes of the gas); Martin v. Glass, 571 F. Supp. 1406, 1412 (N.D. Tex. 1983) (royalty owner is entitled to receive the market price for his gas when processed and was not entitled to share in the increase received from the sale of processed products).

[6] 3 Williams, *Oil & Gas Law: Express Clauses of Oil and Gas Leases* § 634 (1982).

[7] A 1982 arms-length sales contract for gas from the same field, entered into with the Alaska Pipeline Company, reflects a value of $2.05 per Mcf, a value much lower than the approximately $3.00 per Mcf value yielded by DOI's netback calculation.

[8] Ashland Oil, Inc. v. Phillips Petroleum, 554 F.2d 381, 387 (10th Cir. 1975) ("It is obvious that comparable sales or current market price is the best [method of valuation], and second would come the

mentators have concluded that the netback method is even theoretically unsound since it erroneously equates costs of production to value added.[9]

Furthermore, the inherent deficiencies of the netback method are magnified in this case. In the *Ashland v. Phillips* cases [10], netback was employed in the absence of comparable sales by using a downstream contract price for crude helium to arrive at a value for helium entrained in the natural gas stream. In this case, the probability of error is magnified because DOI went further downstream in its netback calculation, starting with the contract price for LNG at dockside in Japan to ascertain a value for natural gas produced in Alaska.[11]

---

work-back method"); Ashland Oil, Inc. v. Phillips Petroleum, 463 F. Supp. 619, 621 (N.D. Okla. 1978), *rev'd on other grounds*, 607 F.2d 335 (10th Cir. 1979) ("Market structures vary at different production stages and correlating figures from one stage to the next can require abstruse analytical calculations, easily resulting in error. If one fact has emerged clearly at retrial, it is the inappropriateness of using refined helium prices as a starting point in extrapolating commingled helium's value at the wellhead."); Northern Natural Gas Co. v. Grounds, Memorandum of Opinion, "The Workback Method", at 50 (D. Kan. Oct. 18, 1983) ("This remarkable spread of values between the separately operated Helex plants . . . occurs when the work-back method is blindly applied, solely upon a mathematical basis. . . .").

[9] *See*, R. Leftwich and S. Yu, *The Workback Method of Valuing Raw Materials: The Helium Cases*, Oil and Gas Tax Quarterly, December 1986, Volume xxxv, No. 2. ("[T]he workback method is virtually useless as a means of determining the value of a raw material. The rationale for its use was not grounded in sound economic theory. . . . [I]t uses accounting procedures and costing to measure value added at each of several processing stages—a task that accounting procedures are not designed to accomplish.")

[10] *Supra*, note 8.

[11] DOI would justify its use of netback here by reliance on the "gross proceeds" language of its regulations, asserting that the

Theoretical considerations aside, and without having to address the use of netback *per se*, it is clear that the application of netback in this case yielded patently unfair and unlawful results. Whereas comparable sales of the same raw natural gas from the same field and in substantial quantities yield a value of about $2.05 per MCF, DOI's netback methodology yields a value of about $3.00 per MCF [12]—a difference in value of fifty percent. That extra increment of value wrongly attributed to the wellhead value actually represents a portion of lessee Marathon's entreprenurial profits to which DOI is not entitled.

Where Congress has contemplated a government share in profits it has done so in explicit terms. For example, in the Outer Continental Shelf Lands Act Amendments of 1978, 43 U.S.C. § 1337(a)(1)(D)-(F)(1982), Congress permits the Department of the Interior to consider a variety of bidding systems, several of which include profit sharing arrangements between lessees and the government. Yet Congress has never prescribed any method other than a traditional percentage royalty for federal onshore oil and gas leases. Absent clear statutory author-

---

landed sales price of LNG in Japan is the gross proceeds for natural gas produced in Alaska, *infra*, section III.

The fallacy of this conclusion stems from DOI's erroneous factual assumption that liquefied natural gas is equivalent to natural gas. Manufacturing LNG requires the removal of water, impurities, and heavier hydrocarbon fractions (particularly pentanes and heavier). Gas chromatographs will show that natural gas and LNG are distinctly and chemically different.

The district and appellate courts' failure to comprehend the marked differences between the natural gas produced and the LNG manufactured from it caused them to lose sight of a fundamental valuation principle: royalty is due on the value of production, not on the value of chemically distinct products manufactured downstream.

[12] The district court has retained jurisdiction to determine the manufacturing and transportation costs which Marathon may deduct in calculating royalties due under the netback method.

ity, DOI cannot confer upon itself the right to collect a net profits share on processed products, either directly or through blind application of a fundamentally flawed valuation methodology.

The Court is committed "to giv[ing] effect to the unambiguously expressed intent of Congress." *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984) (footnote omitted). We submit that the Ninth Circuit mechanically applied standards of deference in this case without the threshold inquiry and finding that Congress' meaning was ambiguous in its use of the terms "royalty" and "production." Congressional clarity obviates any exercise in interpretation by an agency and judicial deference to such an interpretation is erroneous. *Id.* at 842-43. As such, the flawed decision of the Ninth Circuit requires consideration and correction by this Court.

II. The Ninth Circuit Decision Permits DOI Royalty Collection to Undercut Federal Policies Encouraging Domestic Energy Production

By basing royalty on an unlawfully expanded definition of production—which captures the value added by manufacturing—and by using a netback valuation technology, when other far more certain and legal measures of value are available, DOI unlawfully increased the producer's cost of production.[13] This increase in the producer's cost will only create disincentives for producers to engage in domestic exploration and production, an inherently high risk venture.[14] Such a result contravenes

---

[13] This Court has recognized that escalated royalty costs adversely affect the producers' cost of production. See FERC v. Pennzoil Producing Co., 439 U.S. 508, 514 (1979) (FERC is empowered under the Natural Gas Act to grant "an individual producer a rate increase at variance with the established area or national rate in order to accommodate an increase in royalty costs").

[14] *See*, In Re Permian Basin Area Rate Cases, 390 U.S. 747, 756-57 (1968) ("Producers of natural gas cannot usefully be classed

the national policy goals embodied in the federal leasing statutes and Natural Gas Policy Act of 1978 (NGPA)[15] that seek to foster exploration for and development of our Nation's energy resources.

Indeed, this Court has recognized that the overriding goals of natural gas regulation are "assur[ing] an adequate and reliable supply of gas at reasonable prices" [16] and "encouraging the exploration for and development of new sources of natural gas." [17] The comprehensive federal regime of regulation of natural gas prices under the NGPA was intended to preserve and expand incentives for the production of intrastate and interstate gas. Thus, this Court observed that "[i]n each category of gas, the statute explicitly establishes an incentive pricing scheme. . . . The new statutory rates are intended to provide investors with adequate incentives to develop new sources of supply." [18]

With respect to the Mineral Lands Leasing Act, the Court of Appeals for the Tenth Circuit understood that

> [t]he purpose of the [] Act was to promote the orderly development of the oil and gas deposits in the publicly owned lands of the United States through private enterprise.[19]

---

as public utilities. They enjoy no franchises or guaranteed areas of service. They are intensely competitive vendors of a wasting commodity they have acquired only by costly and often unrewarded search.")

[15] 15 U.S.C. §§ 3301 et seq. (1982).

[16] California v. Southland Royalty Co., 436 U.S. 519, 523 (1978); *see also* Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378, 388-89 (1959).

[17] FPC v. Texaco, Inc., 417 U.S. 380, 388 (1974).

[18] Public Service Commission v. Mid-Louisiana Gas Co., 463 U.S. 319, 333, 334 (1983).

[19] Harvey v. Udall, 384 F.2d 883, 885 (10th Cir. 1967) (quoting Senate Subcommittee on the Committee on Interior and Insular Affairs, The Investigation of Oil and Gas Lease Practices, 84th Cong., 2d Sess. 2 (1957)).

In utilizing the netback for product valuation, DOI is undermining congressionally enacted policies which "promote . . . development . . . through . . . enterprise." In twisting the understood meaning of the statute's words "production" and "royalty", DOI has unilaterally elevated maximization of royalty revenues as the dominant goal of the Act. In so doing, it has substantially increased producers' costs of production, thereby discouraging, rather than promoting, their enterprise.

In the Outer Continental Shelf Lands Act, Congress also expressed as a goal for the nation the development of domestic energy resources. In fact, in amending the Act in 1978 Congress declared that the purpose of the Act is, *inter alia*,

> to establish policies and procedures for managing the oil and natural gas resources of the Outer Continental Shelf which are intended to result in *expedited exploration and development of the Outer Continental Shelf* in order to achieve national economic and energy policy goals, assure national security, reduce dependence on foreign sources, and maintain a favorable balance of payments in world trade. (emphasis supplied).[20]

DOI's royalty collection policy as exercised in this case is at odds with congressionally-mandated federal policies which encourage the expeditious development of our na-

---

[20] 43 U.S.C. § 1802(1) (1982). Congress also expressly found, *inter alia*:

> (1) the demand for energy in the United States is increasing and will continue to increase for the foreseeable future;
>
> (2) domestic production of oil and gas has declined in recent years;
>
> (3) the United States has become increasingly dependent upon imports of oil from foreign nations to meet domestic energy demand;
>
> (4) increasing reliance on imported oil is not inevitable but is rather subject to significanct reduction by increasing the development of domestic sources of energy supply. 43 U.S.C. § 1801(1)-(4).

tion's energy resources. It need not be. If DOI properly bases royalty determination on the value of production, its royalty collection program would satisfy all of the federal policies underlying the minerals leasing laws, including collection of reasonable royalties. Reversal of the decision below will restore the proper balance which accommodates all federal policies.

III. Resolution of This Issue Now Is Timely

The Department of the Interior and the courts below have relied heavily on the "gross proceeds" clause in the current valuation regulations to justify their conclusions.[21] Specifically, the district court concurred in DOI's determination that "the net back method was *necessary* to satisfy the gross proceeds requirement." [22] (emphasis supplied). The Ninth Circuit, when it addressed the substantive issue in this case, did not revisit this issue but

---

[21] 30 C.F.R. § 206.103 (1986) provides:

> § 206.103 Value basis for computing royalties. The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any said substance for the purposes of computing royalty be deemed to be less than the *gross proceeds* accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of a like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. (emphasis supplied).

[22] Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1385 (D. Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986).

merely incorporated by reference "the reasons so ably discussed by the district judge in discussing the issues before him. . . ." [32] But use of the netback method in this case was neither necessary nor lawful.

This pivotal "gross proceeds" regulation has existed since at least 1936,[24] but in 1987, the district court's own finding is still true: "The phrase 'gross proceeds' is not defined in the regulations." [25] Application of this regulation, then, necessitates resolution of the point at which "gross proceeds" are calculated to determine the percentage royalty. Marathon correctly asserted, by reference to the Minerals Lands Leasing Act, that the point for measurement of gross proceeds is at the wellhead, whereas DOI marks the point at dockside in Japan. Most unfortunately, the courts below and DOI have ascribed independent significance to the regulation, ignoring the statutory limitation that the federal royalty be based on "the value of production", to the exclusion of value added downstream.[26]

---

[23] Marathon Oil Co. v. United States, 807 F.2d 759, 766 (9th Cir. 1986).

[24] Section 3(e) of the Oil and Gas Operating Regulations, 12/1/36. *See,* United States v. Ohio Oil, 163 F.2d 633, 639 (10th Cir. 1947).

[25] *Marathon,* 604 F. Supp. at 1384.

[26] The district court focused exclusively on the intrinsic context of the regulation itself, losing sight of the delimiting statutory basis from which the regulation flows:

> I agree that the first sentence of the regulation directs the Associate Director to look to sales price in the field. However, the regulation does not end there. In the second sentence, it requires that the royalty basis be not less than the gross proceeds accruing to the lessee. *Id.* at 1384.

The district court discerned a conflict between the first and second sentences where none existed, i.e., the "gross proceeds accruing to the lessee" are those obtained from "sales . . . in the field." *Marathon,* 604 F. Supp. at 1384.

The court reasoned that a " 'proceeds' type royalty clause" will be computed on the basis of aggregate gross receipts from all

This Court's review of the case would be especially timely given the pendency of important and long-awaited product valuation rulemaking by the DOI's Minerals Management Service.[27, 28]

---

products less costs of marketing and transportation. *Id.* at 1384 (citing R. Hemingway, *The Law of Oil and Gas* § 7.4, at 351 (2d ed. 1983)). The case of United States v. Wichita Industries, 390 F. Supp. 1154 (W.D. Okla. 1974) contradicts this conclusion, however, through reference to an Indian lease executed as far back as 1920. The lease provided:

> The lessee hereby agrees to pay . . . the lessor, as royalty, the sum of twelve and one-half percent of the *gross proceeds* of all oil *extracted*. . . . (emphasis supplied). *Id.* at 1155.

The lease provision clearly refers to gross proceeds from sale of production in the field, i.e., *"extracted." See also*: Ashland Oil & Refining Co. v. Staats, 271 F. Supp. 571, 578 (D. Kan. 1967). ("[R]oyalty is not payable on the gathering and transportation charges. We hold, further, that such charges are not "proceeds" from the sale of gas, upon which royalties are payable.")

[27] On February 15, 1986 (51 Fed.Reg. 4507) the Minerals Management Service published an advance notice of proposed rulemaking. On January 15, 1987 (52 Fed.Reg. 1858) the MMS published a notice of proposed rulemaking for valuation of oil. On February 13, 1987 (52 Fed.Reg. 4732) the MMS published a notice of proposed rulemaking for the valuation of natural gas. These rulemakings, expected to be completed in late 1987, are a direct result of the Linowes Commission which, in its report, urged DOI to clarify its product valuation regulations. Commission on Fiscal Accountability of the Nation's Energy Resources (Washington, D.C., January 1982), (the "Linowes Commission").

[28] In its notice of proposed rulemaking, DOI has adopted a prioritized benchmark system for the valuation of products for royalty purposes. In the first instance, DOI will use contract proceeds from arm's-length contracts to determine value. Absent arm's-length contracts, comparable contracts, then other measures of value (e.g., spot prices) are used. Use of the netback method is, however, relegated to the last resort for gas valuation: "If a value cannot be determined using any of the valuation procedures previously mentioned, a net-back procedure to value the gas could be used." 52 Fed.Reg. at 4736 (Feb. 13, 1987); *See also* 52 Fed.Reg. at 1861-2 (Jan. 15, 1987) (proposed oil valuation regulations).

A central issue in the rulemaking is the very definition of gross proceeds and its application. Supreme Court review of this case would, at this important juncture, clarify this central issue of federal oil and gas law.

Federal lessees have never agreed to share with the federal government a portion of downstream entrepreneurial value. The dubious application of the netback valuation method, coupled with DOI's own *post facto* reservations in the pending rulemaking, warrant this Court's plenary review.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

Of Counsel
THOMAS L. CUBBAGE II
1256 Adams Building
Bartlesville, OK 74004

G. WILLIAM FRICK
(Counsel of Record)
DAVID T. DEAL
PHILIP A. COONEY
AMERICAN PETROLEUM INSTITUTE
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8246
Counsel for Amicus Curiae

February 1987

Supreme Court, U.S.
FILED
FEB 26 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1006

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1986

MARATHON OIL COMPANY, an Ohio corporation,
Petitioner,
vs.
UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF RESPONDENT COOK INLET REGION, INC. IN OPPOSITION

MUNGER, TOLLES & OLSON
WILLIAM D. TEMKO,
Counsel of Record
355 South Grand Avenue
Los Angeles, California 90071
(213) 683-9100

Attorneys for Respondent Cook Inlet Region, Inc.

Bowne of Los Angeles, Inc., Law Printers. (213) BOWNE CO

QUESTION PRESENTED

Respondent Cook Inlet Region, Inc. objects to the Petitioner's statement of the Questions Presented. The Petitioner has misstated the basis for the Court of Appeals' decision, and, in so doing, has mischaracterized the questions raised in this case. The only question presented herein is as follows: Whether, under the deferential standard of review prescribed in the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), (E), the administrative royalty orders issued to the Petitioner by the Secretary of the Interior were authorized by the applicable statutes, regulations and lease terms, all of which confer upon the Secretary broad discretionary authority to establish the royalty value of gas produced from Federal leases.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
OPINIONS BELOW	2
JURISDICTION	2
STATEMENT OF THE CASE	2
A. Introduction	2
B. The Secretary Of The Interior's Statutory And Regulatory Authority To Establish The Royalty Value Of Federal Lease Production	3
C. Petitioner's Gas Sales In Japan	6
D. The Royalty Orders Issued To Petitioner By The Department Of The Interior	6
REASONS FOR DENYING THE WRIT	9
The MMS Royalty Orders Were Clearly Reasonable And Fully In Accord With The Mineral Lands Leasing Act, And The Regulations And Leases Issued Pursuant Thereto	9
CONCLUSION	15

TABLE OF AUTHORITIES

Cases

	Page
Aleut Corp., et al. v. Arctic Slope Regional Corp., et al., Civil No. A75-53 (D. Alaska)	3
Amoco Production Co., 29 IBLA 234 (1977)	13, 14
Ashland Oil, Inc. v. Phillips Petroleum Co., 554 F.2d 381 (10th Cir. 1977)	15
Blum v. Bacon, 457 U.S. 132 (1982)	14
Bowles v. Seminole Rock & Sand Co., 325 U.S. 410 (1945)	14
California Company v. Seaton, 189 F.Supp. 445 (D.D.C. Cir. 1960), *aff'd sub nom. California Company v. Udall*, 295 F.2d 384 (D.C. Cir. 1961)	4, 11
Chapman v. Sheridan-Wyoming Coal Co., 338 U.S. 621 (1950)	11
Chevron, U.S.A. Inc. v. National Resources Defense Counsel, Inc., 467 U.S. 837 (1984)	11, 13, 14
Continental Oil Company v. United States, 184 F.2d 802 (9th Cir. 1950)	9, 10, 14
Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984)	13
Kerr-McGee Oil Industries, Inc., 70 I.D. 464 (1963)	12
Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29 (1983)	10
Mountain States Legal Foundation v. Andrus, 449 F.Supp. 383 (D. Wyo. 1980)	4
Supron Energy Corp., 48 IBLA 181 (1980)	13
Udall v. Tallman, 380 U.S. 1 (1965)	14
United States v. Larionoff, 431 U.S. 864 (1977)	10, 14
Wheless Drilling Company, 80 I.D. 599, 13 IBLA 21 (1973)	13

TABLE OF AUTHORITIES

Page

Rules

Rules of United States Supreme Court, Rule 17 .. 11

Statutes

Alaska Native Claims Settlement Act ("ANCSA") § 7(i) of ANCSA, 43 U.S.C. § 1601 *et seq.* 3

Alaska Native Claims Settlement Act ("ANCSA") § 7(i) of ANCSA, 43 U.S.C. § 1606 3

30 C.F.R. § 206.103 .....4, 5, 11

30 C.F.R. § 221.47 ..... 5, 13

5 U.S.C. § 706(2)(A) i

28 U.S.C. 1254(1) 2

30 U.S.C. §§ 181 *et seq.* 4

30 U.S.C. § 189 4

Miscellaneous

Accord: Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5), Sec. II.A.2 and II.B. (May 1, 1977) .. 12

Textbooks

R. Hemingway, The Law of Oil and Gas, 7.4 at 316 (1971, 1979 Supp.) 13, 15

W. Williams and C. Meyers, Manual of Oil and Gas Terms at 5 (5th Ed. 1981) 13

No. 86-1006

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1986

MARATHON OIL COMPANY, an Ohio corporation,
Petitioner,

vs.

UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF RESPONDENT COOK INLET REGION, INC. IN OPPOSITION

Respondent Cook Inlet Region, Inc. ("CIRI") respectfully requests that this Court deny the Petition for a Writ of Certiorari to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit, which appears in the Appendix to the Petition at 2a-17a, was originally reported at 794 F.2d 1461, but then temporarily withdrawn from publication. On January 6, 1987, the Court of Appeals issued a further Order authorizing the opinion to be re-released for publication, but the re-published opinion has not yet appeared in West's bound volumes. The opinion of the United States District Court for the District of Alaska, reported at 604 F.Supp. 1375, appears in the Appendix to the Petition at 22a-53a.

JURISDICTION

The judgment and opinion of the United States Court of Appeals for the Ninth Circuit were entered on July 24, 1986. A petition for rehearing and suggestion for hearing *en banc* was denied by the Court of Appeals on January 22, 1987. Although the petition for rehearing was not timely filed, on October 3, 1986 Justice O'Connor extended the time for filing a petition for writ of certiorari to and including December 21, 1986. The petition herein was filed on December 19, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

A. Introduction

Petitioner Marathon Oil Company ("Marathon") owns a nearly fifty percent (50%) undivided working interest in seven Federal oil and gas leases within the Kenai Field in Alaska (the "Federal Leases"). Under the terms of those leases, Marathon is required to pay the lessors a royalty

equal to twelve and one half percent (12½%) of the value of any oil or gas produced and sold from the leased lands.

Because of conveyances of certain lands to Respondent CIRI pursuant to provisions of the Alaska Native Claims Settlement Act ("ANCSA"), 43 U.S.C. § 1601 *et seq.*, CIRI is entitled to approximately sixty-five percent (65%) of the royalties from oil and gas produced from the Federal Leases, with the remaining thirty-five percent (35%) going to the Federal Government.[1]

B. The Secretary Of The Interior's Statutory And Regulatory Authority To Establish The Royalty Value Of Federal Lease Production

Under the provisions of the Marathon leases, as well as the applicable Federal regulations incorporated by reference therein, the authority to determine the value of any oil or gas produced from the leases, for purposes of computing Marathon's royalty payment obligations to the

---

[1]CIRI is one of the twelve Alaska Native Regional Corporations established by Congress under ANCSA. Pursuant to Section 7(i) of ANCSA, 43 U.S.C. § 1606(i), and the Section 7(i) Settlement Agreement dated June 29, 1982, which was approved by the United States District Court for the District of Alaska on June 3, 1983, *see Aleut Corp., et al. v. Arctic Slope Regional Corp., et al.*, Civil No. A75-53 (D. Alaska), seventy percent (70%) of CIRI's annual net revenues from the subsurface estate conveyed to it under ANCSA is subject to sharing among the twelve Native Regional Corporations. Thus, the other eleven Regional Corporations have a right to receive a percentage of the overall annual net revenue stream generated from subsurface resource development on lands conveyed to CIRI under ANCSA. Accordingly, any royalty payments which CIRI receives from Marathon on gas production from the Federal Leases is included in CIRI's gross subsurface revenues in calculating the amounts subject to sharing among the Alaska Native Community pursuant to Section 7(i) of ANCSA.

lessors, rests with the Secretary of the Interior ("Secretary").

The Mineral Lands Leasing Act, 30 U.S.C. §§ 181 *et seq., as amended*, was enacted by Congress in 1920 "to promote wise development of natural resources and to obtain for the public reasonable financial returns on assets belonging to the public." *Mountain States Legal Foundation v. Andrus*, 449 F.Supp. 383, 392 (D. Wyo. 1980). In Section 32 of the Act, 30 U.S.C. § 189, Congress authorized the Secretary "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of [the Act]. . . ." It is pursuant to that statutory authority that the Secretary has issued regulations and orders regarding the calculation and payment of royalties on Federal Lease production. The courts have held that such regulations have the force and effect of statutes when not inconsistent with or repugnant to the statute in question. *See, e.g., California Company v. Seaton*, 189 F.Supp. 445, 449 (D.D.C. 1960), *aff'd sub nom. California Company v. Udall*, 295 F.2d 384 (D.C. Cir. 1961).

The Federal Leases themselves further reinforce the Secretary's broad authority to establish the royalty value of oil and gas produced from the lease premises. In the initial paragraph of each of the Federal Leases, Marathon agreed to lease the mineral lands in question "subject to the terms and provisions of the [Mineral Lands Leasing] Act, and all reasonable regulations of the Secretary of the Interior now or hereafter in force." Pursuant to Paragraph 2(d)(1) of the Leases, moreover, Marathon, as lessee, is obligated to pay the lessor "12-½ percent royalty on the production removed or sold from the leased lands *computed in accordance with the Oil and Gas Operating Regulations* (30 C.F.R. Part 221) [30 CFR § 206.103]."

Finally, under Paragraph 2(d)(2) of the Federal Leases, Marathon has "expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on . . . gas" removed or sold from the leased lands.

The Oil and Gas Operating Regulations, incorporated by reference in each of Marathon's Federal Leases, establish the applicable standard for determining the value of production for purposes of computing royalties under the Leases:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director [of the Minerals Management Service of the Department of the Interior]. . . . *Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof* or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality . . . gas . . . produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 C.F.R. § 206.103 (1986) (emphasis added) [formerly codified at 30 C.F.R. § 221.47]. It is clear, therefore, that the terms of the Federal Leases, and the regulations by which Marathon expressly agreed to be bound when it executed those Leases, reserve to the Secretary, through the Minerals Management Service ("MMS"), the author-

ity to establish the royalty value of the oil and gas produced from the leased lands.

C. Petitioner's Gas Sales In Japan

Marathon delivers a portion of the gas produced from its Kenai Field leases to its liquified natural gas ("LNG") facility at Nikiski, Alaska, where, through a multi-step cooling process, the temperature of the gas is lowered so as to transpose the gas from a vapor into a liquid. This temperature reduction process does not in any way alter the molecular composition of the gas. Once liquefied, the gas is transported by tanker to Japan, where it is sold by Marathon to two Japanese utilities. The point of first sale of Petitioner's Kenai Field gas shipped to Japan — *i.e.*, the first arm's-length sale following production of the gas — occurs when the gas is sold to those Japanese utilities in Yokohama, Japan.

D. The Royalty Orders Issued To Petitioner By The Department of The Interior

Since as long ago as 1977, the Department of the Interior ("DOI") has disputed the method by which Marathon has valued the gas sold in Japan for purposes of computing its royalty obligations and, over the years, has undertaken efforts to collect additional royalties from Marathon on that gas. For almost eight years, however, Marathon resisted those periodic Federal royalty collection efforts in order to avoid its royalty payment obligations under the Federal Leases. In this royalty enforcement action against Marathon, the Government has sought, once and for all, to put an end to Marathon's eight-year strategy of resistance and delay.

On July 8, 1983, pursuant to its authority to establish the value of production for royalty calculation purposes,

DOI issued an administrative order to Marathon, requiring it to begin paying royalties on the gas sold in Japan based upon the gross proceeds accruing to the company from the sale of the gas. That royalty order was based upon the explicit DOI royalty regulations which establish "gross proceeds" as the minimum royalty value for gas produced from Federal oil and gas leases.

Marathon exercised its right under the DOI regulations to appeal the July 8, 1983 royalty order. Despite that appeal, however, Marathon was obligated by statute, regulation, and the terms of its leases to comply with that royalty order pending any appeal therefrom. Notwithstanding that express obligation, however, Marathon failed and refused to comply with the explicit royalty payment directive set forth in the July 8, 1983 MMS order. In fact, effective April 1983, Marathon began paying royalties on its Japanese gas sales based on an even lower value than it had been utilizing before DOI notified it that it was to begin paying royalties based upon the gross proceeds methodology.

Over the course of the next eleven months, DOI issued two further orders to Marathon regarding its underpayment of royalties on the Federal lease production sold in Japan. However, despite these two additional chances to comply with the MMS directives, Marathon persisted in refusing to make the royalty payments demanded.

On April 14, 1983, even before MMS had issued the first royalty order to Marathon, Marathon filed a declaratory judgment action against the United States, the State of Alaska, and CIRI in Federal District Court in Alaska challenging DOI's authority to require it to calculate and pay royalties based on the gross proceeds methodology proposed by MMS. Marathon later amended that original complaint to challenge the validity of the July 8, 1983

royalty order, as well as the subsequent orders of October 5, 1983 and June 11, 1984. The United States counterclaimed, requesting a court order upholding the validity of the three MMS royalty orders, requiring Marathon to account for and pay all royalties due and owing under those directives, and cancelling Marathon's leases for nonpayment of royalties.

The parties agreed that the underlying issue in the case — the validity and enforceability of the MMS orders — was a question of law that could properly be decided by the Court on summary judgment. Accordingly, the parties submitted the case on cross-motions for summary judgment and a hearing on the parties' respective summary judgment motions was held in the District Court on January 4, 1985. On February 20, 1985, the District Court issued a thorough opinion, 604 F.Supp. 1375 (D. Alaska 1985), granting summary judgment for the Federal Government, upholding the validity of the three MMS royalty orders, and issuing a mandatory injunction in favor of the Federal Defendants[2] requiring Marathon to comply with the terms of the royalty orders and to conduct an accounting of the royalty amounts due and owing thereunder. *See* Appendix to the Petition at 22a-53a. In so ruling, the Court held that the MMS Orders issued to Marathon were within the agency's authority under the applicable statutes and regulations, and neither violated nor were inconsistent with the Federal Leases which, by their express terms, provided for a royalty to be paid on production removed or sold from lease lands computed in accordance with the applicable oil and gas operating regulations. *Id.*, at 43a-45a.

---

[2]The Federal Defendants are collectively the United States of America, the United States Department of the Interior and Donald Hodel, Secretary of the Interior.

The Ninth Circuit, in an opinion written by Judge Wallace, affirmed. Appendix to Petition at 2a-17a. The Court of Appeals endorsed the reasoning of the District Court's thorough and careful opinion and upheld the District Court's determination regarding the validity of the netback royalty orders issued by MMS. *Id.,* at 10a-11a. The Court of Appeals also rejected various other arguments raised by Marathon that had not been explicitly addressed in the District Court's opinion. *Id.*, at 11a-17a.

REASONS FOR DENYING THE WRIT

The Petitioner has grossly mischaracterized the decision of the Court of Appeals. In point of fact, the decision of the Ninth Circuit is clearly correct and fully in accord with the precedent of this Court and of other circuits. Accordingly, the petition should be denied.

The MMS Royalty Orders Were Clearly Reasonable And Fully In Accord With The Mineral Lands Leasing Act And The Regulations And Leases Issued Pursuant Thereto

As the courts have long recognized, the Secretary of the Interior, through MMS, is vested with considerable discretion to determine the value of oil and gas for royalty calculation purposes and to establish the terms and conditions for the payment of such royalties. *See, e.g., Continental Oil Company v. United States,* 184 F.2d 802, 821 (9th Cir. 1950). As noted above, this authority is not only embodied in the relevant statutes and regulations, but is also incorporated directly into the Federal Leases. Thus, as the District Court properly observed below, "[b]oth the regulations and the leases . . . vest in the administrative agency the authority to establish the basis for computing royalties." Appendix to the Petition, at 36a.

MMS' determination that Marathon is required, under the "gross proceeds" language of the regulation, to value the gas at issue based upon its sales price for the gas in Japan (less allowances for transportation and liquefaction costs, as well as a return on investment) is a "reasonable" interpretation of the DOI royalty value regulation. Petitioner cannot demonstrate that DOI's interpretation of the "gross proceeds" language in its own regulations is "clearly erroneous." *See, e.g., United States v. Larionoff,* 431 U.S. 864, 872 (1977). Nor is there any suggestion in the record in this case that DOI officials engaged in fraud, dishonesty, or bad faith in issuing the royalty orders to Marathon. *See Continental Oil Company v. United States, supra.* To the contrary, the record indicates that there was clearly a "rational basis" for MMS's decision to issue the gross proceeds royalty orders to Marathon and that MMS did not "entirely [fail] to consider [any] important aspect of the problem" or offer an explanation for its decision that ran "counter to the evidence before the agency." *See, e.g., Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.,* 463 U.S. 29, 43 (1983). Accordingly, the royalty value determinations at issue in this action were properly sustained by both the District Court and the Court of Appeals.

In short, the decisions of both the Court of Appeals and the District Court to uphold the administrative royalty orders issued by the Secretary in this case can hardly be said to involve the application of novel principles of law. Rather, to the contrary, both Judge Wallace's opinion in the Ninth Circuit and the District Court opinion upon which it relies simply apply longstanding and well-established legal principles governing the judicial review of administrative agency action under the Administrative Procedure Act.

In a desperate attempt to somehow bring this case within the provisions of Rule 17 of this Court, Petitioner contends that, in upholding the royalty orders issued by DOI, Judge Wallace improperly deferred to the Secretary's interpretation of the statutory term "royalty" in the Mineral Lands Leasing Act. In so arguing, however, Petitioner grossly mischaracterizes the decision of the Ninth Circuit below.

Petitioner does not dispute the fact that, under the terms of its Federal Leases, it is obligated to pay the United States a 12½ percent (12½%) royalty "computed in accordance with the Oil and Gas Operating Regulations (30 CFR Part 221) . . .," and that, under those Leases, the Secretary is given explicit authority to "establish reasonable minimum values" for purposes of computing that royalty. Nor does Petitioner dispute the fact that the applicable DOI royalty valuation regulations, incorporated by reference in each of its Leases, expressly provide, in part, that "[*u*]*nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof.* . . ." 30 C.F.R. § 206.103 (emphasis added).

As noted, above, the courts have held that such regulations have the force and effect of statutes when not inconsistent with or repugnant to the enabling statute in question. *See, e.g., Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.,* 467 U.S. 837 (1984) ("Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."); *Chapman v. Sheridan-Wyoming Coal Co.,* 338 U.S. 621, 629 (1950) (A regulation promulgated pursuant to the Mineral Leasing Act has the force of law.). *See also California Company v. Seaton, supra.*

The regulation is unambiguous. It is the Associate Director of MMS who must determine the value of production for purposes of computing royalty, and the value so determined may not be less than the gross proceeds received by the lessee. The gross proceeds accruing to Petitioner from its Japanese gas sales (less allowances for costs of transportation and liquefaction, as well as a return on investment) constitute the *minimum* value of that gas for purposes of computing Marathon's royalty obligation to the United States. *See Kerr-McGee Oil Industries, Inc.*, 70 I.D. 464, 470 (1963) ("In making their negotiations of their sales contracts the appellants were or should have been aware of this regulation expressly providing that *the value basis must be at least as much as the gross proceeds which the lessee would obtain from the sale of the gas. . . .*") (emphasis added). *Accord*: Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5), Section II.A.2 and II.B. (May 1, 1977).

The three MMS royalty orders to Marathon, prepared by DOI only after lengthy analysis and deliberation of the issues within the Department, were issued for one fundamental purpose — to ensure that, in compliance with that explicit and unambiguous regulatory mandate, Marathon was valuing the gas sold in Japan, for royalty purposes, *at no less than its "gross proceeds."* Thus, under those Orders, DOI directed Marathon to begin calculating the value of its LNG for royalty purposes by deducting actual cooling and transportation expenses from the price which it receives for the gas in Japan. This is the "gross proceeds" referred to in the regulations. That term is

commonly understood in the industry. According to Professor Hemingway:

> Royalty payable upon the "proceeds" of the sale of gas, will be computed on the basis of aggregate gross receipts from all products, less the costs of marketing and transportation.

R. Hemingway, *The Law of Oil and Gas*, 7.4 at 316 (1971, 1979 Supp.). Both the courts and the treatise writers have defined "proceeds" in accordance with this commonly accepted dictionary meaning, that is, the amount accruing to the lessee from the sale of its gas. *See* W. Williams and C. Meyers, *Manual of Oil and Gas Terms* at 5 (5th Ed. 1981); *Hoover & Bracken Energies, Inc.*, 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984) (Gross proceeds described as "the amount the producer receives from the purchaser of the gas."); *Supron Energy Corp.*, 48 IBLA 181 (1980) ("Under 30 C.F.R. § 221.47, the value of production for royalty purposes must be at least *equal* to the actual proceeds accruing to the lessee upon sale of the output of the lease.") (emphasis in original); *Amoco Production Co.*, 29 IBLA 234, 236 (1977) ("Proceeds of a sale, unless there is something in the context showing to the contrary, means total proceeds."). *See also Wheless Drilling Company*, 80 I.D. 599, 13 IBLA 21 (1973).

Petitioner's protestations to the contrary notwithstanding, the fact remains that the principal legal issue in this case — whether the royalty orders are consistent with the applicable statutes and regulations — is precisely the type of question on which the courts must defer to the administrative agency. Thus, the agency's interpretation of the applicable statutes is entitled to substantial deference, particularly if the statute in question is one which the agency is charged with administering. *Chevron, U.S.A.*

Inc. v. Natural Resources Defense Counsel, Inc., supra, 467 U.S. at 837, 104 S.Ct. 2782-83; *Blum v. Bacon,* 457 U.S. 132, 141-42 (1982).

Such judicial deference to agency determinations is even more appropriate where, as in this case, interpretation of the agency's own administrative regulation is principally at issue. *Udall v. Tallman,* 380 U.S. 1, 16-17 (1965). As this Court stated in *United States v. Larionoff, supra,* 431 U.S. at 872, "an agency's interpretation of its own regulations is controlling, except where such an interpretation is clearly erroneous." *Accord: Bowles v. Seminole Rock & Sand Co.,* 325 U.S. 410, 414 (1945). This deference to the agency is particularly compelling, moreover, in the area of royalty valuation, where the Secretary is given broad discretion in exercising his regulatory authority to determine, for royalty purposes, the reasonable unit value of production under a specific lease. *Amoco Production Co.,* 29 IBLA 234 (1977). *See also Continental Oil Co. v. United States, supra,* 184 F.2d at 821 (Secretary's royalty value determinations must be sustained in the absence of fraud, dishonesty, or bad faith).

Petitioner seeks to avoid this overwhelming body of case law authority by suggesting that this case involves complicated questions of statutory intent. The fact remains that the key issue in this case is simply this — whether the royalty orders issued by the Secretary were authorized (indeed, if not mandated) by the "gross proceeds" language of the Oil and Gas Operating Regulations.

Petitioner evidently recognizes that the only way it can overcome the presumptive validity of the MMS orders is by arguing that the "gross proceeds" provision in the regulation is simply inapplicable in determining the royalty value of the gas sold in Japan. Thus, Petitioner

suggests that the "gross proceeds" methodology of royalty valuation is inapplicable where, as in the case at bar, the gas to be valued is sold off the lease premises. However, as the courts below recognized, there is nothing at all unusual about using a netback method to establish gross proceeds. As one court has noted, "[t]he work-back valuation is well recognized in the production and early processing of natural gas. It is commonly used . . . in placing a value on feed stock for gasoline plants and related processing." *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381 (10th Cir. 1977) (en banc). Nor is Petitioner correct in its assertion that a netback method is the least preferred method of computing a royalty payment. Regardless of what other methods may be available to compute royalties, if a lease values royalties by reference to "gross proceeds," those proceeds must be computed on the bases of aggregate gross receipts from the product, less allowable costs. *See* R. Hemingway, *The Law of Oil and Gas*, 7.4 at 316 (1971 supp.). Indeed, the fundamental flaw in Petitioner's analysis is its failure to recognize that no matter what the prices of the gas under other contracts in the field may be, if Petitioner's gross proceeds from its own sale of the gas exceed those prices, then Petitioner must pay royalties on the basis of those proceeds. In other words, the netback method is not used as a proxy for determining the market value of the gas but is used to assure that royalties paid on the gas are not based on values that are less than what is actually received by the lessee.

CONCLUSION

The legal principles applied by Judge Wallace in the decison of the Ninth Circuit comport with the precedent of this Court, and do not conflict with the law of other

circuits. Accordingly, for the reasons stated above, Respondent CIRI respectfully requests this Court to deny the Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

DATED: February 23, 1987

Respectfully submitted,
MUNGER, TOLLES & OLSON

By: WILLIAM D. TEMKO
Counsel of Record
355 South Grand Avenue
Los Angeles, California 90071
(212) 683-9100

Attorneys for Respondent
Cook Inlet Region, Inc.

PROOF OF SERVICE BY MAIL

I am a citizen of the United States and a resident of the City and County of Los Angeles; I am over the age of eighteen years and not a party to the within action; my business address is: 1706 Maple Avenue, Los Angeles, California.

On February 23, 1987, I served the within Brief of Respondents in Opposition in re: "Marathon Oil Company vs. United States of America" in the United States Supreme Court, October Term 1986, No. 86-1006;

on the Parties in said action, by placing three copies thereof enclosed in a sealed envelope with postage fully prepaid, in the United States post office mail box at Los Angeles, California, addressed as follows:

Hon. Charles Fried
Solicitor General
Department of Justice
Washington, D.C. 20530

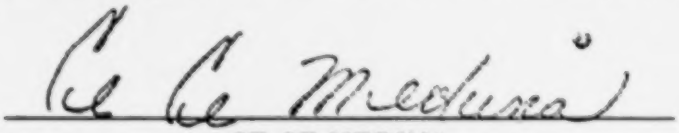
Charles J. Meyers
Gibson, Dunn & Crutcher
1801 California Street, 42nd Floor
Denver, Colorado 80202

Mark P. Worcester
Assistant Attorney General
State of Alaska
1031 West Fourth Avenue, Suite 200
Anchorage, Alaska 99501

All Parties required to be served have been served.

I certify (or declare), under penalty of perjury, that the foregoing is true and correct.

Executed on February 23, 1987, at Los Angeles, California



CE CE MEDINA

Supreme Court, U.S.
FILED
MAR 2 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1006

IN THE

Supreme Court of the United States

October Term, 1986

MARATHON OIL COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITIONER'S REPLY TO BRIEFS IN OPPOSITION

GIBSON, DUNN & CRUTCHER
Charles J. Meyers,
Counsel of Record
A. Randall Farnsworth
Gregory J. Kerwin
Of Counsel:
John A. Carver, Jr.
1801 California Street,
42nd Floor
Denver, Colorado 80202
(303) 298-7200
Attorneys for Petitioner,
Marathon Oil Company

Of Counsel:
D. D. Sandman
G. H. Rothschild, Jr.
K. D. Hinkle

TABLE OF CONTENTS

Page

ARGUMENT 2

I. THIS CASE DOES NOT INVOLVE A ROUTINE APPLICATION OF A LONGSTANDING REGULATION; IT INVOLVES AN ADMINISTRATIVE ORDER IN EXCESS OF STATUTORY AUTHORITY 2

II. THE SECRETARY LACKS AUTHORITY TO COLLECT A NET-PROFITS INTEREST 2

III. DEFERENCE IS NOT APPROPRIATE WHEN AN AGENCY EXCEEDS ITS AUTHORITY AND WHEN ITS INTERPRETATION IS INHERENTLY UNRELIABLE 5

IV. CONCLUSION 6

TABLE OF AUTHORITIES

Page

CASES

Ashland Oil, Inc. v. Phillips Petroleum Co., 554 F.2d 381 (1975), *cert. denied*, 434 U.S. 921 (1977) 4

Chevron, USA, Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 6

Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950) 4

STATUTES AND REGULATIONS

Mineral Leasing Act of 1920, 30 U.S.C. § 226 .....2, 3, 4, 5, 6

30 C.F.R. 206.103 .....2, 3, 4

MISCELLANEOUS

Memo of Sept. 10, 1979 from John Duletsky, Acting Chief, USGS Conservation Division 4

USGS Conservation Division Manual, §§ 647.2.3A, 647.7.5F (Release No. 35, Aug. 15, 1977) 4

IN THE

Supreme Court of the United States

October Term, 1986

No. 86-1006

MARATHON OIL COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA, *et al.*

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITIONER'S REPLY TO BRIEFS IN OPPOSITION

Marathon Oil Company, petitioner herein, by and through its attorneys, Gibson, Dunn & Crutcher, submits this reply to the Brief For The Federal Respondents In Opposition and the Brief Of Respondent Cook Inlet Region, Inc. In Opposition ("CIRI").

ARGUMENT

I. THIS CASE DOES NOT INVOLVE A ROUTINE APPLICATION OF A LONGSTANDING REGULATION; IT INVOLVES AN ADMINISTRATIVE ORDER IN EXCESS OF STATUTORY AUTHORITY

Respondents seek to persuade the Court that this case involves a routine application of a longstanding regulation yielding a standard result. This is not correct. The action of the Secretary of Interior ("Secretary") in this case is not routine; it is unprecedented. The Secretary has adopted a novel interpretation of a longstanding regulation in order to cantilever his authority far beyond statutory bounds. In so doing the Secretary has sought by administrative fiat to replace the Mineral Leasing Act's (MLA) mandate to collect a "royalty" with a mandate to collect a net-profits interest, which is the antithesis of a royalty. The Solicitor General asserts that the Secretary's novel extension of the regulation "presents no issue of general importance warranting review by this Court." *Federal Brief*, at 7. To the contrary, this case concerns fundamental national policy regarding management of mineral resources on public lands. It directly affects all federal oil and gas lessees who use oil or gas as feedstock for such manufactured products as plastics, fertilizer and refinery products. It also has far-reaching importance for judicial review of administrative agency action that departs from congressional mandates expressed in language having a clear commercial meaning.

II. THE SECRETARY LACKS AUTHORITY TO COLLECT A NET-PROFITS INTEREST

The MLA instructs the Secretary to collect a "royalty" on production from federal leases. *Pet.*, at 4; *Federal Brief*, at 2. A net-profits interest is not a royalty. *Pet.*, at 11; *Federal Brief*, at 10, n.6. The Secretary is seeking to collect a net-profits interest from Marathon. The Solicitor General's own counterstatement

of the Question Presented concedes this. The Solicitor General states the issue as whether the Secretary may value gas on the basis of the sale price of a manufactured product, liquefied natural gas, "less allowable costs and deductions for liquefaction and transportation (*including return on investment*)." *Federal Brief,* at I. When the Secretary can determine rate of return, the government captures a portion of Marathon's profits. The lower the rate of return allowed on Marathon's investment, the greater the government's share of Marathon's profits. The Secretary has claimed in the district court that a reasonable rate of return on Marathon's LNG facilities is between 8% and 8.6%, far below what could have been earned by investing in Treasury securities. The Secretary was quite candid in the Ninth Circuit about his intent to capture a share of Marathon's entrepreneurial profits, claiming that this is an inevitable result of the regulation's gross proceeds language. *See Pet.,* at 5, n.3 (quoting *Brief for the United States*).

To effectuate the capture, the Secretary has extrapolated from the statute, which specifies a royalty, and from the regulation, which speaks of gross proceeds from the sale of leasehold production, to an administrative order that demands a share in profits earned solely from a manufacturing and transportation enterprise. There is no sale of production in Japan; sold there is a manufactured product, LNG.[1] The Solicitor General and CIRI try to obscure the point that no leasehold production is sold in Japan by emphasizing the "gross proceeds" sentence in the regulation. The problem masked

[1] LNG is not synonymous with natural gas. *See Pet.,* at 4, n.2. The district court tried to equate the two, *see* 604 F. Supp. at 1386, *Pet. App.,* at 44a, but in so doing inadvertently resolved a genuine issue of material fact against the party opposing summary judgment, Marathon, and against the only evidence before it on this issue (evidence presented by Marathon). The Ninth Circuit recognized the problem, *see* 807 F.2d at 767, *Pet. App.,* at 13a-14a, and tried unsuccessfully to circumvent it by saying the district court did not have to reach the issue.

thereby is whether the government is entitled to collect gross proceeds on sales of a manufactured product or on sales of raw gas produced at the leases. Marathon does not quarrel with the right of the Secretary under the regulation to obtain a share of the gross proceeds from the sale of the gas at the leasehold. Indeed, that is precisely the longstanding construction applied by the Secretary between 1923 and the beginning of the current dispute with Marathon.[2] *See Pet.*, at 10-11; *see also Memo* of Sept. 10, 1979 from John Duletsky, Acting Chief, USGS Conservation Division (Admin. Rec. 124) ("Geological Survey has no authority or need to control costs accruing downstream from the lease meter."); *USGS Conservation Division Manual*, §§ 647.2.3A, 647.7.5F (Release No. 35, Aug. 15, 1977) (describing same policy). But when the Secretary abandoned that construction and sought to share in profits from downstream manufacturing and transportation, he overreached himself; he cannot turn a statutory royalty into a net-profits interest by transmuting the regulation. He could not amend the regulation to require a net-profits interest explicitly; he cannot accomplish the equivalent by an order "interpreting" the gross proceeds sentence in the regulation. That it is reasonable to use gross

---

[2] The two cases the Solicitor General relied on for the proposition that net-back is "well established and accepted in the industry," *Federal Brief*, at 9, are the product of very special circumstances not present here. The lease form in Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950) gave the Secretary unfettered discretion to establish royalty values. Terming the lease provision as "extraordinary," the court held the Secretary's determination was valid absent "fraud or mistake so gross as to imply bad faith." 184 F.2d at 821. No claim is or could be made that the Secretary has unlimited discretion in this case.

Ashland Oil, Inc. v. Phillips Petroleum Co., 554 F.2d 381 (1975) concerned a private action over the value of helium intermixed with natural gas. Helium, though purchased by the government in a stockpiling program, had no market price; the price of the natural gas was fixed by the Federal Power Commission. Under those circumstances the court allowed use of a "work-back" methodology because there was no other way to determine value. The Mineral Leasing Act and Secretarial discretion were not involved.

proceeds from the sale of leasehold *production* as a surrogate for royalty value does not mean that "gross proceeds" equals "net-profits."

The MLA's mandate to the Secretary is precise: to take necessary and proper actions to collect a royalty It is not, as CIRI suggests, to take all necessary and proper actions to obtain a reasonable financial return from public lands. If this Court compares the MLA's clear instruction to the Secretary to collect a royalty with the net-profits interest commanded by the Secretary's order it will see that the Secretary has acted beyond his statutory authority.

III. DEFERENCE IS NOT APPROPRIATE WHEN AN AGENCY EXCEEDS ITS AUTHORITY AND WHEN ITS INTERPRETATION IS INHERENTLY UNRELIABLE

As explained above and in the petition for certiorari, *Pet.*, at 9-12, the MLA's mandate is narrow. The Secretary's authority and discretion is limited in all respects to the collection of a "royalty," a term with a single accepted commercial meaning. *Id.; Amicus Brief of the American Petroleum Institute*, at 3-6. The Court of Appeals evaded the question of whether the Secretary's interpretation of the regulation could be squared with the statute's mandate by invoking the doctrine of deference. The Solicitor General concedes that deference is not appropriate when an agency acts beyond the scope of its authority, and he agrees that courts should apply various criteria to determine whether the agency's interpretation is reliable before deferring. *Federal Brief*, at 10-11. The Solicitor General's *post hoc* rationalization of reliability cannot now cure the failure of the court below to consider those criteria. Contrary to the Solicitor General's assertions, the Secretary's interpretation of the gross proceeds language of the regulation to create a net-profits interest is new and unprecedented. The Department of Interior's Minerals Management Service does

not have expertise in the task it has undertaken — collection of a net-profits interest using a ratemaking methodology. Finally, the Secretary does not have broad policymaking authority here either. The authority bestowed on him by Congress is to collect only a royalty, a portion (in kind or value) of oil and gas produced from public lands. Therefore, deference to the Secretary's legal interpretation was improper.

IV. CONCLUSION

Denial of certiorari will leave standing a precedent for the Interior Department to graft a net-profits interest onto the gross proceeds language of the regulation and onto the venerable term "royalty" in the Mineral Leasing Act. More important, it will greatly expand the "deference" principle explained in *Chevron*, making the administrative function of determining royalty valuation a specialized matter "committed to agency discretion," virtually unreviewable by courts. These are matters of importance both to the orderly administration of the mineral leasing laws and to the allocation of authority between the executive and the judiciary to interpret the law.

WHEREFORE, Marathon Oil Company respectfully requests that this Court grant its petition for certiorari.

Dated: March 1987.

Respectfully submitted,

GIBSON, DUNN &
CRUTCHER
Charles J. Meyers,
Counsel of Record
A. Randall Farnsworth
Gregory J. Kerwin
Of Counsel:
John A. Carver, Jr.
1801 California Street,
42nd Floor
Denver, Colorado 80202
(303) 298-7200
Attorneys for Petitioner,
Marathon Oil Company

Of Counsel:
D. D. Sandman
G. H. Rothschild, Jr.
K. D. Hinkle